CHASE

International Finance

Vol. XIV, No. 19
October 1, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

B1900-1

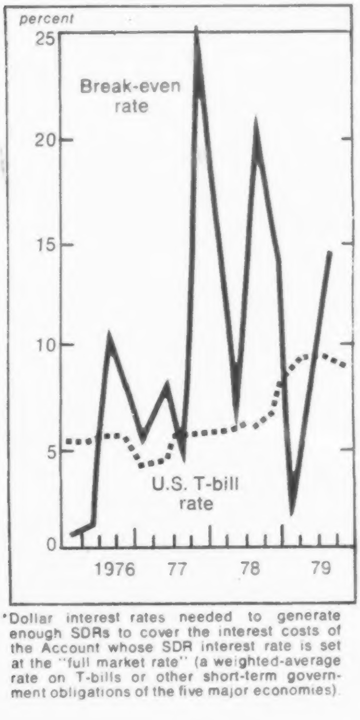
The Dollar Substitution Account

The finance ministers of the five major economies have announced their agreement in principle to the concept of a Substitution Account. Under this arrangement, central banks would deposit U.S. dollar instruments in a special account within the IMF and receive in return an SDR-denominated obligation. The dollars deposited in the Account would then be transferred into some form of U.S. government obligation. Proponents of this idea see it as both working to reduce the potential instability of exchange rates and enhancing the role of the SDR as a reserve asset.

This agreement does not extend to the specific details of the Account, however. Substantial differences of opinion remain as to what is an appropriate yield on the SDR-denominated claims against the Account, what sort of mechanism is appropriate to guarantee the salability of these claims at a price close to par, and what arrangements are appropriate for guaranteeing the preservation of the capital value of these claims. These questions are closely interrelated. If the yield on claims against the Account were set at "market rates," there would be less difficulty in guaranteeing their liquidity but greater difficulty in achieving agreement on how to ensure the Account sufficient funds to pay the interest due on those claims. If the yield were set at the current rate paid on SDRs—80% of the "market rate"—the latter problem is eased somewhat; however, the relative attractiveness of the asset would be reduced and a supplementary mechanism would be needed to guarantee its liquidity.

These details are particularly important to the United States because they define the potential interest cost on those U.S. government obligations held by the Account. The adjacent chart shows what dollar interest rates would have had to be paid to the Account over the past four years if the United States had agreed to assume *all* of the exchange risk involved in guaranteeing the ability of the Account to pay a *full* market SDR rate on its own obligations. This "break-even" rate would have averaged 3% higher than the actual rate on Treasury bills, roughly the same as the average annual rate of depreciation of the dollar against the SDR over that period. With this in mind, the United States has argued that any exchange risk associated with the Account should be shared broadly. Other countries have objected to this position, pointing out that an agreement to share exchange risks means that the claims issued by the Account would have very different characteristics from those of the SDR itself. The establishment of the Account would appear to hinge on the resolution of this conflict.

"Break-even" dollar interest rates* for a Dollar Substitution Account vs. U.S. T-bill rates, 1976-79



*Dollar interest rates needed to generate enough SDRs to cover the interest costs of the Account whose SDR interest rate is set at the "full market rate" (a weighted-average rate on T-bills or other short-term government obligations of the five major economies).

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Heavy speculative pressures prompt a German mark revaluation.

The recent adjustments in European Monetary System (EMS) parities—a 2% DM revaluation and a 3% Danish kroner devaluation—followed a period of intense speculative activity. A review of the EMS had been scheduled for September, and although a parity change was not justified by inflation differentials or current-account balances, foreign-exchange market participants had little to lose by moving into German marks for a limited period. The resultant speculative inflows into DM forced Germany to choose between either revaluing or absorbing large amounts of foreign exchange, which would have expanded the German money stock, lowered short-term rates, and further increased bank loans—all counter to the Bundesbank's strong anti-inflation stance. With no further parity changes likely to occur in 1979, a convergence of short-term rates can be expected. Germany still has room to raise rates somewhat higher, while short-term rates in weaker EMS-member countries are expected to decline relative to German rates because of the near-term reduction of foreign-exchange risk versus the DM.

Swedish economic downturn gathering momentum.

Sweden's new government now faces the prospect of an economic setback after two years of progress, with little political consensus as to what direction the country should take. The rise in oil prices together with the end of a rundown of import inventories threatens a sharp deterioration in the current-account balance. The 1978 deficit of kr. 4.4 billion is expected to widen to at least kr. 8 billion this year—and possibility to as high as kr. 13 billion. Additional foreign borrowings will probably be necessary to finance the expanding deficit, and interest rates will very likely be raised to encourage capital inflows. Looking to the longer term, the recent acceleration in Sweden's rate of inflation—consumer prices are now up 8.3%, year-on-year, versus 5.9% in January—threatens to erode export competitiveness and hinder efforts to reduce the balance-of-payments deficit. Furthermore, labor market conditions point to a renewed bout of wage drift that will complicate the November negotiations on a new national wage settlement.

Brisk Yugoslav growth spurred by investment boom.

Yugoslavia's economic performance has trended upward since 1976, paced by rapid industrial growth. The industrial growth rate was 9% for the first half of 1979, a level which has been sustained for nearly two years. The major stimulus to the economy has been capital investment, which grew more than 15% in real terms during 1978 and is growing at a 10% rate this year. The strong domestic demand, however, has boosted industrial prices and nominal incomes, raising the cost of living more than 12½% in the first half of 1979. On the trade front, surging imports pushed the trade deficit above $3 billion in the first half of the year, with a deficit of $5½ billion likely for the full year. As a result, financing of investment has now been restricted, and a 60-day price freeze was imposed in early August. Thus, Yugoslav growth rates are expected to decline during the last half of 1979, with a GDP growth rate of 6.5% expected for the full year. The slowing trend is expected to continue through next year, with moderate GDP growth of 4%-5% anticipated for 1980.

Brazil: optimism despite high inflation.

The tenor of business opinion in Brazil is generally optimistic, despite indications of imbalances in the economy. The rate of inflation in August, for example, reached 5.8%, the highest monthly advance since 1964. Assuming only moderate increases through year-end, the inflation rate would reach 60% by December. Also, higher oil imports are swelling the current-account deficit, which could reach $9 billion in 1979, compared with $5.9 billion last year. At the same time, debt service and outstanding debt are reaching new highs. Still, Brazil's access to international finance remains unimpaired, and domestic businesses share the positive attitude. Under the new Planning Minister, Delfim Netto, Brazilian policy has shifted from demand-restriction to supply-expansion as the basic means of combatting inflation. The intention is to lower the rate of inflation gradually over the next year or two with the hope that industrial and agricultural export growth rates are strong enough to reverse the disturbing trend of expanding current-account deficits.

Double revaluation for Austrian schilling.

Responding to accelerating inflation, Austrian authorities revalued the schilling against the DM by 1.5% in early September. When the DM was subsequently revalued by 2% within the European Monetary System (EMS), the schilling maintained its parity with the German currency, thereby resulting in a total schilling revaluation of some 3.5% vis-à-vis all other EMS currencies except the Danish kroner. At the same time, the Central Bank tightened credit by effectively raising the discount rate; although the official discount rate remains at 3.5%, banks must now pay 5.5% for central bank discounts beyond 70% of their discount ceilings. This split rate is estimated to have raised the average discount rate to 4.1%. The schilling revaluations should reduce inflationary pressure immediately, stabilizing the inflation rate at the current 4%, but the higher interest rates are likely to raise the real cost of borrowing and act to slow the economy.

Kenya posted a record trade deficit in 1978.

Kenya's external accounts deteriorated sharply in 1978; lower coffee and tea prices trimmed export receipts 16%, while import payments climbed 42%. The record imports resulted from significantly higher defense outlays and expanded domestic demand in the wake of the 1977 coffee and tea boom. Kenya's current account swung from a $57-million surplus in 1977 to a $656-million deficit last year, paralleling an unprecedented $645-million trade gap. Foreign reserves fell 32% to $365 million over the same period. Credit restrictions and import controls intended to redress the deterioration in the foreign accounts will have only a moderate impact this year, as imports—80% of which consist of petroleum and capital goods—are of limited compressibility. Moreover, coffee earnings are expected to fall 25%-30% because of lower prices and rain-damaged crops. Thus, substantial trade and current-account shortfalls in the $500-$550-million range appear likely, auguring continued belt-tightening policies into 1980.

Afghanistan's economy weakened by political disruption.

Afghanistan's trade deficit is expected to worsen in the current fiscal year. Nearly all of the country's exports are agricultural commodities or processed agricultural goods, and the Government's recently-completed land reform program—combined with political disturbances in rural areas—has disrupted agricultural production. On the import side, low rainfall has hurt this year's wheat crop, necessitating a high level of wheat imports to meet domestic consumption requirements. Import growth of intermediate and capital goods has slowed, however, as progress on development projects has been hindered by political disruption and related transportation problems. Overall, the Afghani trade deficit is expected to widen to over $100 million in fiscal 1979/1980 from about $80 million last year. The larger trade deficit, coupled with both a significant drop in foreign-exchange remittances associated with the expulsion of Afghani workers from Iran and reduced tourism earnings, also promises a higher current-account gap this fiscal year.

Cobalt prices have quadrupled since 1977.

The price of cobalt, a metal essential to the production of jet engines, has more than quadrupled over the last two years. Contributing factors have included: (1) strong demand for aircraft and capital goods; (2) supply disruptions in Zaire, the source of one-third of world output; (3) the late-1976 cessation of U.S. strategic stockpile sales, which had contributed 30%-40% to market supply; and (4) depressed conditions in the markets for copper and nickel, from which cobalt is mined as a by-product. Sharply higher prices have spurred efforts to boost supply; these include increased scrap recovery in the United States where there is no mine production. Efforts to develop substitutes have also been stepped-up. The official producer price for cobalt since last February has been $25 per pound, versus only $6.40 in early 1978, and free-market prices were as high as $43 per pound earlier this year before additional supplies brought prices back to their current level of around $27. Barring further disruptions in Africa, market conditions should continue to ease as the U.S. recession spreads to the capital equipment industries. But the extent of any price weakness will be limited by the desire of the United States and other countries to increase stockpiles.

The Fed's Wait-and-See Stance

The Federal Reserve appears to have established the target for the Federal funds rate at around 11½% to 11¾% for the time being. (The brief spurt in the rate at the end of last week was considered temporary and technical.) The sustained rise in the Federal funds rate, which began in mid-August, totaled about 75 basis points. During the past six weeks, the Fed's discount rate was increased to 11%, and short-term money market rates such as bank CDs and commercial paper rose around 150 basis points. The sharper advances in these latter rates, of course, reflected pronounced shifts in expectations about the course of interest rates in coming months. During much of the late spring and early summer, 90-day CD and paper rates were 50 basis points or so *below* Federal funds. At their recent peaks they were about 25 points *above*, but subsequently spreads narrowed to around 10 points.

Indications that the Fed intended to maintain the Federal funds rate in the vicinity of 11½% came from money market intervention patterns several days after the September 18 meeting of the Federal Open Market Committee. Indeed, market expectations of such action were spurred by the Federal Reserve's announcement on September 19 of the discount rate increase from 10½% to 11%. There had been some anticipation the increase would be larger, possibly to 11½%, in which case the Federal funds rate would have been pushed higher as well. As it was, however, three of the seven Federal Reserve governors dissented from the 11% action, preferring instead to stay at the previous 10½% level. This manifestation of strong differences of view within the Fed regarding near-term policy suggests a somewhat more cautious approach at this time by the Fed to further interest rate increases.

The anticipation that Federal Reserve policy will take a "wait-and-see" stance in the near term rests on at least four assumptions about monetary and economic conditions: First, the accelerated growth of M_1 and M_2 in the third quarter–10% and 12½% respectively–will not carry into the fourth; nor will the Fed seek to offset that bulge with a new below-trend operating target. Second, the downward trend of U.S. output will continue, generating strong advances in the unemployment rate. Third, although the inflation rate may not improve much for several months to come, it will not get worse. And finally, while the dollar may be assumed to remain under some pressure, foreign-exchange markets will remain relatively orderly. In short, near-term Federal Reserve policy is expected to be reactive to any developing problems, rather than preemptive. Along this line, however, it is premature to contemplate the Fed easing interest rates. In fact, during the next month or two, rates are considerably more likely to go higher than lower.

Federal Deficit Still a Question Mark

As fiscal 1980 gets under way, the ultimate size of the 1980 Federal budget deficit is still an open question. When the budget was first introduced in January, the President proposed a deficit of $29 billion, the result of planned outlays of about $532 billion and expected receipts of $503 billion. Now that the budget process has worked its way through Congress, which has upped both the revenue and expenditure targets by some $16 billion each, it still appears that the projected deficit will be around $30 billion. However, the entire debate over the projected deficit may become academic if the economy behaves much differently from what Congress expects.

When the Administration prepared the budget, it included certain economic assumptions in its anticipations of revenues and expenditures. Critics in Congress and in the economics profession questioned these assumptions as overly optimistic, since the projections failed to take into account the possible severe downturn or recession that many forecasters were predicting. Since that time, Congress has adopted a more realistic forecast of the economy in 1980. The current version of the budget that has survived the Congressional debate is based on these assumptions. However, many economists still find the projections overly optimistic and expect the recession to push the deficit well above $30 billion.

A recession usually serves to widen the Federal budget deficit in two ways. First, tax receipts fall short of projections because of declines in business activity and the reduced rate of growth of personal income. Second, Federal transfer payments expand as the rate of unemployment rises. Inflation, on the other hand, can have the opposite effect. As it increases nominal personal incomes, it also pushes taxpayers into progressively higher tax brackets. As a result, personal income tax receipts tend to grow faster than the rate of inflation when tax rates remain unchanged. Government expenditures, however, show no necessary tendency to outpace inflation. During fiscal 1979, for example, the Consumer Price Index rose by about 12%; Federal revenue, however, climbed by almost 16%, while expenditures grew by only about 10%. In fiscal 1980, expenditures are estimated to grow at about the same rate. But the deficit will rise because recession will weaken receipts more than inflation stimulates them.

One result of the inflation-induced rise in personal income tax collections is the increased likelihood of a cut in tax rates. The ratio of personal tax payments to personal income has climbed to about 15%–the level that typically precedes a tax cut. Further favoring a tax reduction are the downturn in economic activity, which has turned Congressional attention toward fiscal stimulus, and the impending hike in the Social Security payroll tax scheduled for January 1980. Any tax cut, of course, further increases the probability that the fiscal 1980 deficit will exceed $30 billion.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1978		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				September 26, 1979			
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves in millions of dollars	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
Austria	Economic growth strong; schilling revalued to reduce inflation.	Feb.	+5.5%	42.1	+1.5%	July	4,824	−4.1%	3.3	0	Current-account deficit in first half below year-earlier level.	June	+3.2%	Apr.	+15.0%	3.75%	.0785	Rates firm following schilling revaluation.	**Austria**
Belgium	Growth rate of 2.5% officially forecast for 1980, along with rise in inflation rate to 6%.	May	+9.1%	68.2	+1.6%	July	7,327	+33.2%	1.7	0	Heavy government borrowing abroad covers current-account deficit.	July	+4.8%	Mar.	+11.1%	9.00%	.035236	Rates remain high with franc under pressure in EMS.	**Belgium**
Britain	Gradual economic slowdown apparent following spring peak.	July	+4.3%	245.6	+3.2%	July	21,073	+19.9%	3.0	1,138	First-half current-account gap tops $4 billion, despite North Sea oil sales.	Aug.	+15.8%	Mar.	+4.7%	14.00%	2.1930	Interest rates remain high.	**Britain**
Denmark	Growth slowing, but high oil prices boost pace of inflation.	Mar.	−2.8%	41.0	+1.0%	July	3,993	+34.5%	3.0	0	January-July trade deficit of kr. 11.5 billion, vs. kr. 8.5 billion last year.	June	+8.6%	May	+4.2%	11.00%	.1932	Discount rate raised to 11% to bolster kroner in EMS.	**Denmark**
Finland	GNP growth rate expected to be very high in 1979.	Apr.	+6.7%	27.5	+2.5%	May	1,676	+57.5%	2.4	131	January-July trade surplus of 1.09 billion markkaa, vs. 1.07 billion year-earlier.	June	+7.2%	Feb.	+5.7%	7.25%	.2660	Rumors of revaluation persist.	**Finland**
France	Commitment to current anti-inflationary policies remains fragile, despite domestic activity.	June	+4.8%	377.1	+3.3%	June	19,066	+64.6%	2.5	0	Current-account to remain in small surplus, despite growing trade deficit.	Aug.	+10.8%	Dec.	+12.4%	9.50%	.2422	Interest rates rise to support the franc.	**France**
Germany	First-half real GNP up 4.3% above year-earlier; growth set to weaken.	July	+7.6%	469.1	+3.1%	July	53,007	+29.0%	4.1	0	Current-account moves into deficit as trade surplus is sharply reduced.	Aug.	+4.9%	Apr.	+12.9%	5.00%	.5680	Speculative inflows lead to DM revaluation.	**Germany**
Ireland	Despite slowing growth, GDP growth remains highest of EEC countries.	Jan.	+5.2%	9.4	+7.0%	July	2,182	+3.3%	3.2	0	Trade figures remain weak, but offsetting capital inflows maintain reserves.	May	+12.4%	July	+35.8%	13.70%	2.1075	Interest rates remain at near-record levels.	**Ireland**
Italy	Strikes depress output somewhat, but demand still strong; 4.5% growth expected in 1979.	June	0	194.4	+2.6%	July	21,498	+58.7%	4.0	342	Drop in current-account surplus expected, despite strong tourist receipts.	Aug.	+15.5%	Dec.'78	+11.2%	10.50%	.001235	Lira remains buoyant in EMS.	**Italy**
Netherlands	Economy buoyed by fast German growth, but slowdown expected next year.	May	+2.8%	90.9	+2.5%	July	9,549	+19.8%	2.0	0	Oil price rise boosts value of gas reserves.	July	+3.7%	May	+18.5%	8.00%	.5135	Credit conditions moderately restrictive.	**Netherlands**
Norway	Anti-inflationary policies have reduced year-on-year price increases to 4.4%.	June	+4.1%	32.4	+3.5%	July	3,962	+21.3%	4.1	0	First-half trade deficit of kr. 3.35 billion, about half year-earlier gap.	July	+4.8%	May	+15.1%	7.00%	.2018	Central bank moves to tighten credit.	**Norway**
Portugal	Parliament approves escudo 20-billion increase in budget deficit.	Dec.	+4.6%	17.1	+3.2%	June	1,620	+29.7%	3.8	240	Talks resumed with IMF regarding $50-million loan.	June	+30.3%	Mar.	+19.6%	18.00%	.0210	Interest rates maintained at high level.	**Portugal**
Spain	Medium-term economic plan cuts 1979 GDP growth target to 2.5%.	June '78	+5.4%	110.7	+2.9%	Apr.	11,724	+54.8%	6.8	267	Reserve position continues to strengthen, reaching record level.	May	+15.6%	May	+15.5%	8.00%	.0153	Tight money policy continues to restrain credit demand.	**Spain**
Sweden	Formulation of economic policy delayed by inconclusive election results.	May	+5.7%	70.2	+2.8%	July	4,008	−10.5%	2.0	0	Jan.-Aug. trade gap of kr. 2.8 billion, vs. kr. 3.1-billion surplus year-earlier.	July	+6.6%	Apr.	+21.7%	8.00%	.2412	Measures to limit monetary growth taking effect.	**Sweden**
Switzerland	Growth expected to weaken, but outlook for inflation improves.	Mar.	+2.9%	55.2	+0.9%	July	17,558	+37.2%	7.9	0	Trade deficit for first half tops SF 1.5 billion.	Aug.	+4.0%	Apr.	+9.7%	1.00%	.6365	Authorities unwilling to tighten monetary policy further.	**Switzerland**
Turkey	New agreement with IMF signed; monetary and fiscal policy to be tightened.	May	+4.7%	40.7	+3.2%	July	1,490	+53.3%	3.8	678	Foreign-debt renegotiations end; foreign-exchange crisis eases somewhat.	Mar.	+38.2%	Nov.	+33.7%	10.00%	.0275	Credit conditions restrictive.	**Turkey**
Canada	Economic growth slowing because of trade effects of U.S. recession and inflationary pressures.	June	+3.1%	184.6	+3.4%	July	4,239	−7.7%	1.0	0	Decline in long-term capital inflows.	Aug.	+8.4%	Apr.	+21.0%	12.25%	.8563	Central bank and prime rates raised.	**Canada**
United States	Accumulating inventories result in August production declines and increased unemployment.	Aug.	+2.3%	1,754.9	+4.0%	July	20,903	+8.0%	1.3	0	Current-account improvement expected in 1980, despite higher oil bill.	Aug.	+11.8%	Aug.	+13.1%	11.00%	—	Fed maintains tight money policy.	**United States**

World Interest Rates

market rates as of September 26, 1979; bond yields as of September 21, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	12.25	14.00	9.00	9.50	5.00	10.50 penalty rate 13.50	8.00	1.00	5.25
Day-to-Day Money	11.6875 Sept. 27	11.50	13.625	11.35	11.50	5.00	11.50	8.75	0.375	7.00
Treasury Bills 91-day, Middle Rates	10.20	11.55	14.375	12.50 120-day	12.16 one year	n. a.	10.50 94-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	11.50 finance paper	12.00 finance paper 15% tax w/h	12.66 H. P. on discount basis	8.90 Certified	11.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.55	11.90 15% tax w/h	14.00	11.00 Certified	not traded	7.40	12.625	no market	3.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.11	10.75	12.34	9.17 20% tax w/h	10.74	7.52	13.21	8.77	3.52	7.59
Industrial Bonds prime, long-term, new and old issues, average yield	9.85 Aa Industrials	11.125	12.79	11.90 20% tax w/h	11.95	7.83	13.42	9.26	4.36	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	13.25	13.00	15.00	13.00	10.10	7.25	15.50	11.00	4.00	5.50
Bank Time Deposits 3-month	11.50 Cert. of Dep.	12.00 Cert. of Dep.	14.0625 Cert. of Dep.	12.50	11.75	7.75	8.50	10.125 large deposits	1.75 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	12.50	no market	14.0625	no market	13.125	7.3125	no market	9.375	1.5625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8563	2.1930	.035236	.2422	.5680	.001235	.5135	.6365	.004497
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.625 *P*	1.625 *D*	1.00 *D*	.50 *D*	5.00 *P*	2.50 *D*	3.00 *P*	11.00 *P*	5.00 *P*

Eurodollar Deposits
(London, interbank, bid)
September 27

7-day	11.875
1-month	12.125
3-month	12.625
6-month	12.625

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.35
U.S.-Canada Treasury Bills	−1.50
U.S.-Canada Finance Co. Paper	− .96
Eurodollars-U.K. Local Auth. Deposits	+ .13

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.25
Over 7 yrs.	10.25
DM Bonds	
7 yrs. and under	7.00
Over 7 yrs.	7.35

Gold Price
London
afternoon fixing

373.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.8 (Aug.)	8.4 (Aug.)	15.8 (Aug.)	10.8 (Aug.)	4.9 (Aug.)	15.5 (Aug.)	4.0 (Aug.)	4.2 (July)
Industrial production*	2.0 (Aug.)	2.4 (July)	4.3 (July)	4.8 (June)	7.6 (July)	3.7 (July)	3.0 (June)	9.4 (July)
Trade balance† *(billions of local currency units)*	−$2.36 (Aug.)	C$0.08 (July)	−£0.10 (Aug.)	−FF3.17 (Aug.)	DM0.98 (Aug.)	−Lt388 (July)	−SF0.59 (July)	−¥140 (Aug.)
Money supply (M₁)*	4.9 (Aug.)	6.3 (Aug.)	12.4 (July)	12.3 (July)	11.1 (Aug.)	23.2 (Apr.)	9.0 (June)	11.1 (Aug.)
Velocity of money (M₁)*	6.6 (June)	6.3 (Mar.)	−4.0 (Dec.)	n. a.	−3.1 (Mar.)	−5.6 (Dec.)	n. a.	−4.0 (Mar.)
Reserves *(millions of U.S. $, end of period)*	20,903 (July)	4,239 (July)	21,073 (July)	19,066 (July)	53,007 (July)	21,498 (July)	17,558 (July)	25,379 (July)

* Percent change from 12 months earlier

† Figures are only for the month indicated

Soviet and East European Debt Perspectives

After having succeeded in steadily paring down their combined hard-currency trade deficit from $12 billion in 1975 to $7 billion in 1977, the Soviet Union and its East European partners in the Council for Mutual Economic Assistance (CMEA) saw their hard-currency trade balance worsen last year. Despite continued efforts to bring trade with the West into balance, the combined deficit of the Soviet Union and the East European countries grew by $1.8 billion to $8.8 billion in 1978.

The Soviet Union suffered the worst setback, with a $1.9-billion rise in its hard-currency trade gap to $3.4 billion. Hungary's deficit widened by $460 million to $825 million and Romania's increased by $250 million to $700 million. Bulgaria and the German Democratic Republic were able to stabilize their hard-currency deficits close to their 1977 levels, at $235 million and $1.4 billion respectively. The only two countries that recorded slight improvements in their hard-currency balances were Poland and Czechoslovakia. Poland cut its deficit by $375 million to $1.8 billion, and Czechoslovakia reduced its shortfall by $186 million to $400 million.

Reduced CMEA-country growth rates, particularly in the agricultural sectors, resulted in supply shortfalls that had to be made up by increased imports. At the same time, the slowdown in economic growth has for the most part blocked achievement of planned export growth targets. Prospects for an improvement in the CMEA's hard-currency trade balance this year appear slim. Although the 1979 plans set more realistic production and investment target growth rates, the first-half-year results indicate that some countries may be hard put to achieve even the more modest growth targets. Preliminary projections point to an overall CMEA hard-currency trade deficit in the $8.5-$9-billion range in 1979.

The CMEA's net hard-currency debt (drawings on medium- and long-term official Western export credits, supplier credits, and liabilities to Western banks, less reserves held on deposit with the banks) grew by 17% last year to an estimated $60.7 billion (see table). The estimated net debt exposure for individual countries in 1978 was as follows: Soviet Union, $17.2 billion; Poland, $16.8 billion; German Democratic Republic, $8.2 billion; Hungary, $5.7 billion; Romania, $4.4 billion; Bulgaria, $3.4 billion, Czechoslovakia, $2 billion; and the two CMEA banks—the International Investment Bank (IIB) and the International Bank for Economic Cooperation (IBEC)—$3 billion.

The largest part of the overall CMEA debt in 1978—about 58%—was owned to Western commercial banks; official Western export credits accounted for some 38% of the total CMEA debt, and supplier credits, for about 2%.

The proportions of CMEA debt sources vary from country to country. In the case of the Soviet Union, Western official credits accounted for 70% of its total debt while the commercial banks' share of the Soviet debt was 26%. For the other countries the proportions were reversed—commercial bank credits accounted for 50% to 80% (in the case of Hungary, 98%) of their total debt, while the share of official credits ranged from 20% to 36%.

Of the estimated $23 billion in outstanding official Western export credits, the Soviet Union's share was a little over 50%. Poland was next, with 23% of the total. France, Germany, Japan, Britain, Italy, and Austria were among the major Western suppliers of these official credits.

The CMEA's net liabilities to Western banks rose by $7 billion to $37 billion at end-1978. The individual country breakdown shows Poland with the largest net exposure to the banks ($10.9 billion), followed by Hungary ($5.5 billion), the German Democratic Republic ($5 billion), the Soviet Union ($4.5 billion), Bulgaria ($2.7 billion), Romania ($2.3 billion), and Czechoslovakia ($1.4 billion). The estimated net lia-

CMEA External Debt Summary: End-December 1978

($ million)

	Soviet Union	Eastern Europe	IIB, IBEC
Estimated outstanding official export credits	12,200	10,828	—
Outstanding supplier credits[1]	500	1,000	—
Net liabilities to Western banks[2]	4,463	27,791	3,000
Outstanding IMF, IBRD credits[3]	—	916	—
Total Net Debt	17,163	40,535	3,000

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1) A forfait obligations.

2) Banks in the Group of Ten countries, Switzerland, Austria, Denmark, Ireland, and offshore branches of U.S. banks in the Bahamas, Cayman Islands, Panama, Hong Kong, and Singapore.

3) Applies to Romania—$366 million in IMF drawings and $550 million in outstanding World Bank loans.

Soviet and East European Debt Perspectives *(continued from page 7)*

bilities of the two CMEA banks to Western banks totaled $3 billion.

About 45% of the CMEA's total net debt to Western banks was owed to British-based banks—$17 billion at end-1978. Claims of U.S. banks (both domestic and foreign offices) on the CMEA stood at $5.7 billion at end-1978, accounting for about 12% of total Western bank claims on the area and a little over 2.5% of U.S. banks' global claims.

The maturity distribution of the CMEA countries' liabilities to Western banks shows that 40% of total CMEA liabilities of $47.6 billion at end-1978 were short-term—up to one year. Outstanding loans with maturities of over two years accounted for 30% of the total and those of one to two years, for 10%. Undisbursed credit commitments to the CMEA at end-1978 covered about 25% of total outstanding loans.

The share of Eurocurrency balances in the CMEA's total net liabilities to the banks rose by $3.9 billion during the year to $22.6 billion at end-1978. Borrowings on the Eurocurrency market accounted for 65% of the CMEA's liabilities to the banks—$31 billion at end-1978. During 1978, the CMEA raised a total of $3.7 billion in publicized medium-term Eurocurrency credits, close to the 1977 level of $3.4 billion. The volume of medium-term Eurocurrency loans raised by the CMEA during the first eight months of 1979 reached $2.5 billion.

In absolute terms, the magnitude of CMEA overall external indebtedness is not alarming since it is the world's second largest industrial growth area. It is also not surprising that about 70% of the overall CMEA debt is concentrated in three countries—the Soviet Union, Poland, and the German Democratic Republic—which are the most industrially advanced.

The overall CMEA debt-service cost (repayments on principal and interest payments on medium- and long-term debt) reached $12 billion during 1978. In 1979, the area's debt-service cost is expected to reach a level of about $14 billion.

The non-merchandise trade earnings of the six East European countries, estimated at about $2 billion, was more or less sufficient to cover interest payments. Non-merchandise earnings of the Soviet Union, estimated at over $3½ billion, were far in excess of its interest payments.

The aggregate CMEA debt-service ratio (repayments of principal and interest payments on medium- and long-term credits as a percentage of hard-currency merchandise exports) was 39% in 1978 and is expected to breach the 40% level in 1979. The Soviet Union's 26% debt-service ratio was the lowest in the area, and Czechoslovakia's 28% was the second lowest. Bulgaria and Poland were the two countries with the highest debt-service ratios—both above 60%. The debt-service-ratio levels of Romania, the German Democratic Republic, and Hungary were in the 35%-40% range.

Each country has a distinctive approach to debt management. Self-liquidating credit arrangements with Western capital goods suppliers are the linchpin of the Soviet Union's debt-management policy. Better known as compensation deals, such arrangements involve purchases of Western plant and equipment and technology with payment in Soviet products. Compensation deals account for over 35% of the Soviet Union's overall debt.

Soviet officials claim that there are more than 60 projects at various stages of development in the Soviet Union that are based on compensation arrangements with Western equipment and technology suppliers. Estimates of hard-currency earnings to be generated through these deals in the period 1981-1985 range between $14 and $16 billion.

The energy crunch

For the East European countries, the rising cost of energy imports is a pressing problem. The burden of escalating costs of Soviet oil and natural gas deliveries, under the new pricing formula introduced in 1975, will limit their ability to divert available resources to boost exports to the West. Since the adoption of the new pricing formula, designed to bring intra-CMEA prices closer to world levels over a period of five years, the terms of trade of the six East European CMEA members versus the Soviet Union have been deteriorating because of their heavy reliance on Soviet raw material and energy supplies.

The combined cost of Soviet oil and gas deliveries to the East European countries in 1978 rose by more than $1 billion to an estimated $7.7 billion. This includes some Soviet crude oil supplies sold to East European buyers over and above contractual quotas at world prices. This year, further price increases will result as a partial adjustment to the sharp rise in world oil prices.

Soviet oil and gas exports to Western industrialized countries and to the developing nations accounted for a little over 60% of its total hard-currency exports valued at $13.2 billion in 1978. There appears to have been no increase in the volume of Soviet oil exports to non-Communist countries (the Soviets stopped publishing tonnage statistics) so that the increase in the value of their oil exports was made up by higher prices. On the other hand, exports of Soviet natural gas have increased in volume under existing long-term contracts.

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Chase World Information

CHASE

International Finance

Vol. XIV, No. 20
October 15, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

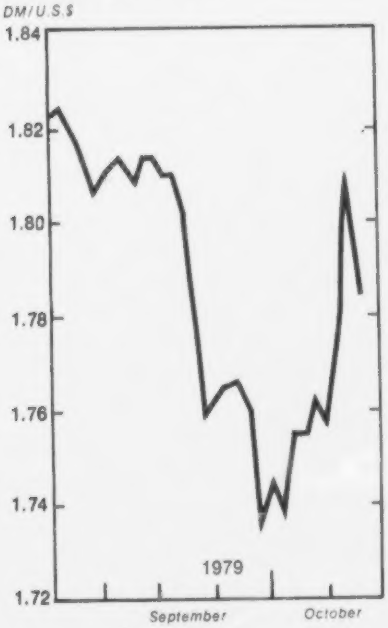
The Fed's Surprise Package

The timing of the Federal Reserve Board's dollar-relief package was hardly a surprise, but the contents were. The market expected something of a replay of the events of last November—coordinated intervention with enlarged central-bank swaps lines, additional sales of foreign-currency-denominated U.S. Treasury liabilities, and another upward ratchet in the discount and Federal funds rates. And in the United States, at least, the increase in domestic short-term interest rates was expected to be modest. The package actually announced was much more powerful—a one-percentage-point discount rate hike with a promise of more to come if use of the discount window increases; relatively stiff marginal reserve requirements on so-called "managed bank liabilities"; and the announcement of a shift in the Fed's operational tactics from control of short-term interest rates to management of bank reserves. Moreover, the Treasury option of issuing additional DM-denominated debt remains to be exercised.

The reaction of the foreign-exchange markets has been favorable up to now. Although a hard core of suspicion remains that the new-found U.S. resolve to control inflation will weaken in the course of an election year, Chairman Volcker seems to have made his point. By designing a surprise package that suggests both long-term and short-term objectives, the Fed has forced the market to reconsider its expectations concerning future U.S. inflation. The one-sided and potentially disorderly market conditions of two weeks ago have been replaced by a two-sided uncertainty about the future course of the dollar.

Two further points need underscoring. First, although the tenor of the foreign-exchange and commodities markets determined the timing of the policy move, the substance of the package is at least as much oriented to domestic as well as external objectives. The jury is still out on the question of whether foreign considerations will be given significantly greater weight in the formulation of U.S. monetary policy by the Volcker Board. Second, the announced shift in the Fed's tactics of monetary control toward management of the monetary base should not be interpreted as a shift toward "monetarism." Indeed, if there is a doctrinal implication of the move, it is that doctrine is being abandoned. The Board is saying that the monetary aggregates need to be brought under stricter control, and that is hardly a uniquely monetarist conclusion.

The dollar's DM exchange value



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Massive U.K. wage demands weaken sterling.

The start of the annual round of wage negotiations in the United Kingdom has created some uncertainty in foreign-exchange markets. From an exchange value of $2.26 and DM 4.14 at end-July, sterling began to fall and show wide daily fluctuations; as of the end of September its value had dropped to $2.20 (against a weak dollar) and DM 3.84. While the round was launched with the usual massive wage demands, actual settlements are expected to be significantly less. Last year's round, for example, opened with wage claims exceeding 30%, but total earnings rose by only 14% over the year. A similar pattern is expected for this year; indeed, the Government's tight monetary stance now threatens workers with the stark choice between jobs and wages. Even at current levels, sterling is sufficiently strong to create problems for exports, while high interest rates and rising prices threaten a marked slowdown in both investment and consumer demand—all of which could lead to almost no growth in output in fourth-quarter 1979 and in 1980. Thus, actual wage settlements are likely to come in well below current demands, perhaps at close to the 14% figure of 1978. Settlements of this order would restore some market confidence in sterling, whose oil-based buoyancy will be highlighted as the December 19 OPEC meeting approaches.

Italian economic growth will slow dramatically in 1980.

Italy's inflation rate in the first eight months of 1979 was an annualized 17%, the result of continuing rapid monetary expansion—the narrowly-defined money stock in April was up 23% from the year-earlier level—and the latest round of oil price increases. For 1979 as a whole, official forecasts are for real GDP growth of over 4%, largely attributable to rapid real growth during the first quarter. In 1980, real growth is expected to decline sharply to 1.5%, assuming no change in current policies. The gloomy growth outlook, however, has prompted the new Government to propose a modestly reflationary budget for 1980 aimed at raising real growth to 2.5%. Personal tax allowances are to be increased and a $3.7-billion housing program will be instituted. Partially offsetting these stimulative measures will be hikes in public utility charges and higher property taxes. If these measures are enacted, Italy's 1980 public-sector borrowing requirement could rise to some 40 trillion lira from an estimated 36 trillion in 1979.

Norway's restrictive policies have produced solid results.

The stringent economic policies in place since early 1978 are generating better results than previously thought for the Norwegian economy. Aided by increased oil production, GDP has begun to grow rapidly, and the recent upturn in exports and investment expenditure may boost the 1979 growth rate to the 4% level. Despite more rapid growth, the trade deficit for the first eight months of 1979 narrowed to 2.43 billion kroner, versus kr. 3.31 billion for the comparable year-earlier period. The inflation rate remains slightly above 8%, with July wholesale prices up 8.2% and August's up 8.4%. The financial community expects the brisk pace of growth to continue well into 1980 with the year-on-year growth rate pushing 6%, despite further measures to curb bank lending announced in August. If the economy performs as well as is expected, Norway would be one of the few European countries to see a 1980 growth rate higher than in 1979.

Japanese foreign direct investment patterns have shifted.

Japan's foreign direct investment rose 64% to $4.6 billion in the fiscal year ending March 1979. The increased Japanese investment abroad went mostly to industrialized, primarily North American, countries and the Middle East. Until 1975, the bulk of Japanese overseas investment was in the manufacturing sectors of developing countries, mainly Asian, to exploit the availability of raw materials and cheap labor. Investment in the more advanced countries was limited to the non-manufacturing sectors associated with the promotion of Japanese exports. Since 1975, however, patterns of Japanese foreign direct investment have shifted, with the industrialized nations the recipients of heavy and growing Japanese investment. Indeed, total Japanese investment in North America has now surpassed that of Asia, and the investment has been concentrated in the manufacturing sectors of the North American countries. Reasons for the shifts in Japanese overseas investment patterns include the marked expansion in the Japanese balance-of-payments surplus; the appreciation of the yen, which makes exports from Japan less competitive; an effort to assuage the criticism of the industrialized countries; and the desire to tap the sophisticated labor force of the industrialized world. The patterns are expected to be sustained with increased Japanese investment channeled to the industrialized countries, very probably at the expense of investment in lesser-developed areas.

Peru's economy on upswing, but inflation and weak investment persist.

Peruvian economic indicators for the first half of 1979 point to continued economic improvement. Real GDP is estimated to have risen more than 3% following several years of decline, while the budget deficit narrowed as the growth of revenues exceeded the growth of expenditures by nearly 35%. On the trade front, results are also positive. A cutback in imports, a resumption of oil exports, mineral price increases, and the positive impact of economic policies on non-traditional exports are expected to generate a trade surplus of over $1 billion this year, up from $340 million in 1978, and markedly better than the average annual deficit of more than $750 million posted in the 1975-1977 period. Still, the bright outlook is clouded by continuing high inflation—the annual average rate exceeds 60%—and sluggish private investment. While the authorities are combatting price increases by further tightening the growth of the monetary aggregates, restoration of private-sector confidence ultimately depends on sustained improvement in the country's economic development.

Foreign remittances play key role in South Yemen's economy.

Expatriate remittances are a mixed blessing for South Yemen's economy. While they enhance the country's balance-of-payments position, they swell domestic liquidity and create inflationary pressures. Remittances, derived mainly from Yemeni workers in Saudi Arabia and other Gulf States, have risen from an estimated $55.8 million in 1975 to $257.7 million in 1978. The consequent increase in foreign reserves has been the primary cause of the growth in the money supply, which averaged nearly 34% in the 1976-1978 period. The future development strategy will depend heavily on the return of skilled workers, but also on the continued receipt of foreign exchange. Thus, the increase in state expenditure forecast for the 1979-1983 development plan—74 million dinars per annum, versus 39 million annually in the previous plan—is designed to encourage South Yemenis to return home. And although the rate of increase in foreign remittances is officially forecast to decline from this year onward, such earnings still play a major role in the country's economy.

Tin prices high, with stockpile-release actions delayed.

World tin markets continue buffeted by the uncertain prospects for U.S. stockpile legislation. With tin consumption continuing to exceed production, tin prices remain well above the $6.82-ceiling established by the International Tin Council. The ceiling has been ineffective because the Council's buffer stock has had no tin available to sell, and legislation to release tin from the U.S. strategic stockpile—which currently contains an excess of 170,000 tons over requirements—has been delayed. As many as eleven bills were introduced in Congress in 1977 and 1978 that dealt directly with the issue of tin stockpile releases, but these have all bogged down in procedural difficulties. Currently, the Mollohan Bill, which has been passed by the House and will be taken up by the Senate this month, would release 35,000 tons, 5,000 of which would serve as the U.S. contribution to the ITC buffer stock. If this bill passes, significant downward pressure would be brought to bear on tin prices.

New Fed Strategy: Unanswered Questions

The Federal Reserve will place greater emphasis on the behavior of bank reserves and less emphasis on limiting short-run fluctuations in the Federal funds rate—at least during the next few months—according to the Fed's announcement on October 6. This shift of focus from the price of credit to the supply of money and credit has been proclaimed by many analysts, and indeed has the potential to be, the most significant monetary policy development in decades. There is still a great deal of uncertainty, however, over whether this announcement actually will be translated into a *major* shift in the Fed's conduct of monetary policy.

One unanswered question is how long this new operating strategy will remain in effect. In the Fed's announcement, it was noted that this change was adopted "to support the objective of containing growth in the monetary aggregates *over the remainder of this year* within the ranges previously adopted by the Federal Reserve." Thus, it is not clear whether this policy shift will continue into the 1980s.

The extent to which the Federal funds rate will be allowed to fluctuate in order to control the growth of bank reserves is also uncertain. While the Fed did say that wider fluctuations in the funds rate would be permitted, it also noted that there will still be constraints on the short-run volatility of the funds rate.

The Fed has also not yet specified *which* measure of reserves it plans to control. Chairman Volcker has indicated that movements in both total and nonborrowed member bank reserves, as well as in the monetary base, will be taken into account in determining policy. But the relative weights attaching to these different measures have not yet been revealed by the Fed.

Finally, the Fed has not disclosed what growth rate of bank reserves—however measured—is consistent with its targets for money (M_1 and M_2) growth. Indeed, it is likely that the Fed *does not know* with any great degree of accuracy what growth rate of reserves is necessary to achieve its desired money growth targets. Determination of this "desired" growth target for reserves has in fact been made more difficult by the imposition of marginal reserve requirements on banks' "managed liabilities" not included in M_1 or M_2 (such as Eurodollar deposits and repurchase agreements), a step which was part of the October 6 program.

All in all, it will probably take some months to accumulate much evidence on the degree to which the conduct of monetary policy will actually shift, or how such a policy change will be reflected in the tactics of open market operations. For now, the significant development is that the Fed has indicated a resolve to place more emphasis on controlling the supply of bank reserves.

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE			
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered
Asia	**Afghanistan**	Land reform program and political unrest disrupt agricultural production.	June	− 3%	3.9	$ 215	July	405	+ 30%	12.3
	Bangladesh	Jute price floor set to encourage production, curtailed by drought last year.	Mar.	+47%	7.8	95	Aug.	408	+ 37%	3.1
	Burma	Real growth may reach 6% in FY 1979/80, reflecting excellent harvest.	June	+45%	4.3	135	Aug.	188	+ 29%	6.9
	China, People's Republic	Slower growth planned for 1979 to cool the economy.	June	+40%	445.0	450	Dec.	2,413	− 1%	2.2
	Hong Kong	Despite U.S. slowdown, export-led growth is maintained by aggressive marketing elsewhere.	July	+36%	13.3	2,904	n.a.	—	—	—
	India	Grain output may decrease 10% this year as a result of severe drought.	June	+ 3%	140.4	219	May	7,481	+ 22%	10.9
	Indonesia	Unexpected boom in primary commodities exports will boost GNP growth to 7% in 1979.	Mar.	+ 5%	44.6	319	Aug.	3,355	+ 35%	6.0
	Japan	Investment in new plant and equipment expected to rise 13% in FY 1979/80.	July	+ 7%	956.4	8,324	Aug.	25,475	− 14%	3.7
	Korea	Strong deflationary measures will slow growth to a more moderate 7%-8% this year.	June	+20%	46.0	1,242	July	2,594	+ 2%	2.1
	Malaysia	Strong exports and quickening investment pace point to healthy growth prospects.	May	+36%	14.7	1,140	June	3,763	+ 34%	7.6
	Pakistan	Wheat crop up 10% from last year; sugar and cotton production drop.	Jan.	+15%	17.0	218	July	323	− 60%	0.5
	Philippines	Energy squeeze and strong inflationary pressure sapping growth of economy.	May	+34%	23.7	511	July	2,145	+ 16%	4.8
	Singapore	Higher oil prices and utility charges likely to dampen industrial activity.	June	+32%	7.5	3,205	Apr.	5,366	+ 25%	5.0
	Sri Lanka	Lower agricultural output cuts annual GDP growth to 5% from 8% year-earlier.	Apr.	+ 8%	2.4	170	Aug.	453	+ 27%	5.8
	Taiwan	U.S. recession is affecting major exports and will moderate GNP growth to 7%-8% in 1979.	July	+15%	23.5	1,304	July	1,555	+ 3%	5.9
	Thailand	Satisfactory harvests and strong demand for exports help maintain growth at 7½%-8%.	June	+32%	20.5	452	July	2,246	+ 1%	4.7
Oceania	**Australia**	New anti-inflationary budget inspires business confidence; labor unrest remains key challenge.	Aug.	+27%	104.9	7,377	July	2,425	− 10%	1.4
	New Zealand	Slowdown in government spending expected to weaken growth prospects.	July	+31%	13.8	4,409	July	791	+ 3%	2.2

Economy at a Crossroads

The Federal Reserve's latest discount rate hike and related actions further cloud the already uncertain U.S. growth outlook. With the economy buffeted by a gasoline shortage during the spring, real GNP fell at an annual rate of 2.4% in the second quarter. Many economists heralded this figure as evidence that the long-awaited recession had arrived. But with improved availability of gasoline, the business outlook brightened in the third quarter, and advance estimates show that the economy grew slightly. Unemployment dropped back to 5.8% in September, after rising to 6.0% in August from 5.7% in July. And inflation not only continued unabated, but showed some signs of acceleration, as consumer prices rose 1.2% in August and producer prices advanced 1.4% in September.

The new Fed actions are intended to help reduce inflation. But the initial effect will be a further slowing of the economy. So far, consumer spending for goods and housing has borne the brunt of the slowdown, and it is likely that these sectors will continue to deteriorate. Housing starts are already 11% below their year-ago levels and are expected to move considerably lower in the months ahead. Mortgage rates at 12% or higher will tend to choke off some demand for funds, and the combination of higher market rates and lower net funds inflows (with the specter of outflows) will reduce the supply. And even though interest rates on most other consumer loans have not risen, and are not likely to rise because of legal barriers, net extensions of consumer credit totaled only $2.5 billion in August (compared with an average of $3.5 billion per month in the first six months of the year) and are expected to slow further or contract, dampening consumer spending.

Businesses are likely to be affected more by the latest shift in monetary policy in the near term. Higher interest rates make the existing high level of inventories more burdensome. Unless sales pick up—an unlikely prospect—production cutbacks will spread outside the auto and other consumer durable industries. However, until inventories are aligned with sales, cash flow and profits will suffer. With less money available to spend, factories operating at lower rates of utilization, and borrowing costs increased, investment in plant and equipment is likely to fall.

There seems to be little doubt that the economy will slow in the coming months, but the severity and duration of weakness are by no means certain. In the first place, it is not yet clear how high interest rates will rise as a result of the current shift in Fed policy. Nor is it clear what the fiscal policy response will be to rising unemployment as the spring primary elections approach. A tax cut sometime next year is widely anticipated, but the magnitude and timing depend upon how quickly the economy deteriorates. And even if inflation drops below double-digit levels early next year, as the Government expects, it will still be uncomfortably high by historic standards.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
of IMF lit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate October 10, 1979	exchange rate in U.S. dollars October 10, 1979	current monetary conditions	
0	Trade deficit expected to top $100 million in FY 1979/80.	n.a.	n.a.	Feb.	+ 83%	—	.0250	Interest rates raised to encourage deposits.	**Afghanistan**
18.0	Growing workers' remittances boost international reserves.	June	+14%	May	+ 17%	—	.0710	Tight credit conditions continue.	**Bangladesh**
0.9	High world market prices for teak boost export earnings.	June	+ 4%	n.a.	—	—	.1550	Credit expanded to cooperative and private sectors.	**Burma**
—	Rapid import growth to continue in 1979.	n.a.	—	—	—	—	.6650	Government agrees to borrow in yen from Japan Eximbank.	**China, People's Republic**
—	Strengthening Hong Kong dollar reducing cost pressure on exports.	July	+12%	June	+ 36%	—	.2035	High interest rates to be maintained.	**Hong Kong**
0	Rising oil prices widen trade deficit, despite export buoyancy.	June	+ 5%	May	+ 19%	9.00%	.1235	Interest rates raised in nonpriority sectors to curb inflation.	**India**
0	Strong export earnings will increase reserves beyond $4.5 billion by year-end.	July	+26%	Jan.	+ 40%	—	.001650	Credit still tight to combat inflation.	**Indonesia**
0	August current-account deficit of $1.5 billion vs. surplus year-earlier.	July	+ 4%	June	+ 12%	5.25%	.004440	Bank of Japan continues to curb commercial bank lending.	**Japan**
5.8	Rapid OPEC income growth to spill over into demand for Korean exports.	July	+18%	July	+ 37%	15.00%	.0022	Further credit tightening expected.	**Korea**
0	Prices of all major exports continue on uptrend.	July	+ 3%	May	+ 14%	—	.4630	Low interest rates maintained to spur investment.	**Malaysia**
3.0	Reserve level continues to decline as aid flow decreases.	July	+12%	May	+ 24%	10.00%	.1020	Credit conditions eased for exporters.	**Pakistan**
7.0	Narrow export base and weak foreign demand will hurt in coming months.	July	+21%	June	+ 27%	4.00%	.1365	Credit squeeze in effect to fight inflation.	**Philippines**
0	Electronics and petroleum products lead rapid export growth.	July	+ 3%	May	+ 19%	—	.4670	Prime rate expected to hit 10% by year-end.	**Singapore**
1.0	Oil import bill tops $500 million in first half.	July	+ 7%	May	+ 35%	10.00%	.0675	Credit tightened to control inflation.	**Sri Lanka**
0	Surge in metal/machinery exports offset by textile/electronics slowdown.	July	+11%	May	+ 41%	12.50%	.0290	Credit restrictive to curb inflation.	**Taiwan**
5.0	Government contemplating new measures to boost manufacturing exports.	June	+ 4%	Feb.	+ 35%	12.50%	.0510	Double-digit inflation prompting tight liquidity measures.	**Thailand**
1.0	Rising service payments exacerbate current-account deficit.	June	+ 9%	May	+ 13%	—	1.1230	Low budget deficit should ease pressure on interest rates.	**Australia**
7.0	Current-account deficit widening because of higher services payments.	June	+12%	Apr.	+ 26%	13.00%	.9955	Credit conditions remain tight to curb inflation.	**New Zealand**

World Interest Rates

market rates of October 10, 1979; bond yields as of October 5, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	13.00	14.00	10.00	9.50	5.00	12.00 penalty rate 15.00	8.00	1.00**	5.25
Day-to-Day Money	13.25 Oct. 11	14.00	13.50	12.00	11.50	8.40	12.50	9.625	0.375**	6.8125
Treasury Bills 91-day, Middle Rates	11.67	12.50	14.3125	13.00 120-day	n. a.	n. a.	10.60 82-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	12.75 finance paper	13.10 finance paper 15% tax w/h	12.66 H. P. on discount basis	9.90 Certified	12.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.50	13.00 15% tax w/h	14.00	12.00 Certified	not traded	7.40	13.25	no market	3.00** not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.34	11.125	12.41	9.24 20% tax w/h	10.26	7.54	13.26	8.72	3.50**	7.56
Industrial Bonds prime, long-term, new and old issues, average yield	10.10 Aa Industrials	11.625	12.89	12.08 20% tax w/h	11.79	7.83	13.61	9.19	4.68**	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	14.50	13.75	15.00	13.50	10.10	7.25	15.50*	11.50	4.00**	5.50
Bank Time Deposits 3-month	12.875 Cert. of Dep.	12.85 Cert. of Dep.	14.00 Cert. of Dep.	12.25	12.125	8.20	8.50	10.625 large deposits	1.8125** residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.625	no market	14.125	no market	13.00	7.8125	no market	9.9375	2.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8576	2.1685	.03420	.2380	.5597	.001209	.5046	.6194	.004428
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *P*	.15 *P*	1.00 *P*	.85 *P*	6.45 *P*	2.00 *D*	4.45 *P*	12.30 *P*	7.20 *P*

Eurodollar Deposits

(London, interbank, bid)
October 11

7-day	14.25
1-month	14.8125
3-month	14.875
6-month	14.8125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.60
U.S.-Canada Treasury Bills	−1.56
U.S.-Canada Finance Co. Paper	−1.42
Eurodollars-U.K. Local Auth. Deposits	+ .53

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.15
Over 7 yrs.	10.80
DM Bonds	
7 yrs. and under	7.50
Over 7 yrs.	7.75

Gold Price

London
afternoon fixing

413.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Rate rises to 16.50 Oct. 15.
** Market rates as of Oct. 3; bond yields as of Sept. 28.

Structure and Growth of Latin American GDP: 1960-1978

	Structure		Average annual real growth						
	1960-64	1970-74	1961-65	1966-70	1971-74	1975	1976	1977	1978*
	(percent)					(percent)			
Primary Sector (agriculture, mining)	20.1	15.4	4.5	2.6	3.5	−0.7	2.3	5.0	2.3
Secondary Sector (manufacturing, construction, power, transportation, communications)	35.5	39.5	5.6	7.5	8.7	3.2	5.4	4.9	5.3
Tertiary Sector (commerce, financial and other services, government)	44.4	45.1	5.5	6.0	7.7	4.2	4.7	3.9	4.0
Gross Domestic Product	100.0	100.0	5.3	5.9	7.5	3.1	4.7	4.5	4.3

*Preliminary

Source: Inter-American Development Bank

Latin American Economic Outlook

The economic outlook for the Latin American and Caribbean region is for moderate growth over the next several years as it, together with the world economy, adjusts to the problems of inflation and higher oil prices. Real GDP growth for the Latin American region was 4.3% in 1978, down from the 4.5% rate of 1977. The slight deceleration was due to a recession in Argentina and output or growth declines in Peru, Nicaragua, Jamaica, Chile, Venezuela, and Costa Rica. The major growth advances in 1978 were recorded by Brazil, Mexico, and Colombia. This year, further regional growth slowdown is anticipated, with a projected GDP growth rate of about 4%.

Although these growth rates are higher than the 1%-2% forecast for the United States and other major industrial countries for this period, the Latin American countries have sustained significantly higher growth rates in the past. From 1970 to 1974, for example, prior to the quadrupling of OPEC prices, Latin American growth averaged 7% per annum.

The recession and high inflation in the United States and other major economies is a serious concern for Latin America; it could translate into both slower demand for Latin American exports and higher import prices. Manufactured exports are particularly sensitive to world demand conditions; this could hit Brazil—which is expected to see its current-account deficit widen from $5.9 billion in 1978 to $9 billion this year—especially hard. Mexico and Argentina, however, should take up some of the slack with strong output advances. Venezuela and Ecuador, on the other hand, are likely to slow somewhat in response to policies of restraint, while Chile and Colombia should maintain respectable 6% growth rates. For Central America, the severe economic disruption in Nicaragua has resulted in a large output decline for that country and slower growth for the entire region. In the Caribbean, the oil-producing economy of Trinidad and Tobago is constrained by public-spending restrictions aimed at maintaining more orderly development, while Jamaica and the Dominican Republic are pursuing restrictive fiscal and monetary policies to curb inflation, debt, and correct payments imbalances. (In the Dominican Republic, the added burden of repairing hurricane damage further constrains economic expansion.) For the remaining countries in the region, the need to combat inflationary tensions at a time of slower world economic growth will lead to subdued output gains in both 1979 and 1980.

Inflation has been a perennial problem in Latin America, and there are few signs that it will abate any time soon. Average prices rose 40% for the region as a whole in 1978, propelled by rates of 176% and 39% in Argentina and Brazil. Mexico did succeed in paring its inflation rate to 18%, and the rate of Chilean price increases was cut from 92% to 40% between 1977 and 1978. But in such countries as Peru and Jamaica, prices nearly doubled and tripled from 1977 to 1978. Through the first nine months of 1979, inflationary pressures remained a concern for all of the major Latin economies. Brazil is currently struggling with a 50% rate; Argentina's price rises are surging at about 160%; Mexico is trying to cut its inflation rate below 18%; and Chile seems to have reached a lower limit of 30% price increases. For these and other countries in the region, inflationary pressures demand constant vigilance and adoption of traditional macroeconomic policies of restraint and slowdown. While a favorable inflation prognosis cannot be confidently predicted for the Latin American region over the next one or two years, all of the countries in the region are highly sensitive to the problem and are all formulating policies to moderate price pressures. One such policy is import liberalization, which seeks to increase the available supply of domestic goods and thereby reduce the overall rate of price increases.

Balance-of-payments trends

The Latin American region posted a $14.5-billion aggregate current-account deficit in 1978, $3.5 billion higher than in 1977. A major source of the widening deficit was the unprecedented $4.4-billion current-account deficit in Venezuela, whose oil export earnings were overtaken by strong. import demands. Argentina's payments balance was healthy—posting a current-account surplus of more than $2 billion—reflecting both weak import demand and strong agricultural exports. Brazil and Mexico both ran large current-account deficits in 1978, though they were easily financed by international capital flows. The expectation for 1979 is for an increase in the Latin American aggregate current-account shortfall to $16 billion, primarily because of a larger (oil-induced) deficit in Brazil and continuation of a $2.5-billion deficit in Mexico. By 1980, however, the aggregate Latin American current-account gap is expected to begin declining as Venezuela's trade account shifts into large surplus as a result of higher OPEC prices, and as Brazil realizes gains under its import replacement projects—while at the same time sustaining its export momentum. The more optimistic balance-of-payments outlook for the region, however, presupposes only a moderate world economic slowdown.

The larger balance-of-payments deficits of recent years have meant an increase in the overall international debt of the Latin American region. For individual countries such as Brazil and Mexico, the outstanding debt is sizable in total terms and the pressure of servicing this debt puts a substantial demand on export and services earnings. In most cases, however, the debt is being channeled productively for long-term investments. And although the aggregate debt may continue to rise for a few more years, many countries in the region are reaching the point where their export earnings will be sufficient to begin reducing their overall external debt exposure.

Import liberalization policies and the growth of manufactured exports are two important economic developments that have evolved in the last several years in Latin America. The trend toward freer imports has been led by the countries of the Southern Cone—Argentina, Chile, Brazil, and Uruguay—which have taken bold steps to trim tariffs and phase out other import barriers.

On the export side, the position of manufactured goods exports has strengthened considerably; such exports now account for 20% of the Latin American total. For Brazil and Mexico, as well as other important Latin American exporters of manufactures, there are considerable benefits in the form of both additional foreign exchange and diversification of exports plus higher investment, productivity, and real incomes. The growth of manufactures, however, has not necessarily meant the decline of basic commodities exports. Indeed, almost without exception, every country has begun to redirect investment toward agriculture, both for domestic needs and for export.

The growth of the petroleum sector has been another major factor of importance, affecting foreign trade and the economies of a number of Latin American and Caribbean countries. Mexico is a well-publicized case in point. But the region also includes two members of OPEC—Venezuela and Ecuador—and another net oil exporter, Trinidad and Tobago. Peru has also achieved oil self-sufficiency, while Argentina is close to it. And Paraguay is destined to become the world's largest electricity exporter in a few years when the massive Itaipu hydroelectric project is completed. Among the major economies, Brazil is the most affected by its need to import large quantities of oil; it is currently making substantial efforts to increase the proportion of gasoline produced from sugar cane and to augment hydroelectric generation.

Status of economic integration efforts

The arguments for greater economic integration of the Latin American region have generally centered on the benefits of larger-scale manufacturing and economic activities, greater competition, removal of trade restrictions, and some evolution towards greater political cooperation. But progress toward integration has been slow or even negative. The conflict in Nicaragua, in particular, has dealt a serious blow to trade in the Central American Common Market (CACM). The Andean Common Market (ANCOM) has made slow progress in trade liberalization, although considerable steps have been taken in the industrial location plans of the member countries. And in the oldest of the integration efforts, the Latin American Free Trade Association (LAFTA), progress toward the goal of a common market by the end of 1980 has all but been abandoned. The organization has had great difficulties in agreeing on trade barrier reductions and economic integration among its members. More promising smaller-scale economic integration efforts, however, are being made among the members of the River Plate Basin Group (Brazil, Argentina, Bolivia, Paraguay, and Uruguay) and among the Caribbean countries in the Caribbean Group for Cooperation in Economic Development.

Political and social evolution

Over the past year, the most notable political changes in the Latin American and Caribbean region have been the several shifts from military to civilian governments. The most complete break occurred in Ecuador, where a free election has produced a civilian president for the first time in eleven years. And the military governments in Peru and Bolivia have either indicated an interest in, or already taken concrete steps toward, more democratically-elected regimes. Last year, a free and open election was held in the Dominican Republic and a more liberal government emerged. In Nicaragua, a revolutionary guerrilla movement has succeeded in toppling a decades-old dictatorship and replacing it with a more broadly representative junta. Among the major countries, Argentina, Brazil, and Chile continue under military rule, but to varying degrees, each of these governments has indicated possible timetables to pave the way toward openly-elected regimes. Although difficult to characterize for such a heterogeneous region, it seems that political evolution over the next several years will be toward more openly-contested political administrations, along the lines of the pluralistic systems in Venezuela, Colombia, Costa Rica, and Mexico. For all of the countries, military and civilian alike, the major social challenge ahead is the achievement of better conditions for an estimated 30% of the 340 million Latin Americans that still lack some of the essential elements for human well-being.

A. Blake Friscia

CHASE

International Finance

Vol. XIV, No. 21
October 29, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

With this issue, International Finance *introduces a unique feature: Eurocurrency market growth data and forecasts compiled by Chase, to appear once each quarter on page 8.*

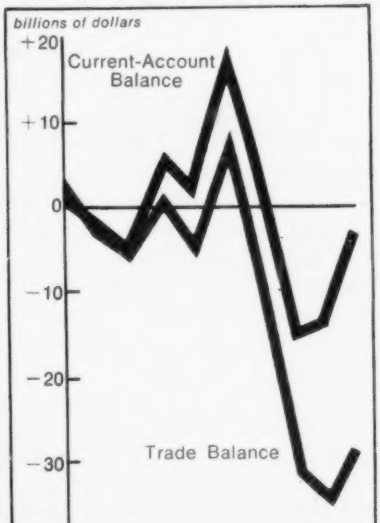
Behind the U.S. Current-Account Improvement

Members of the Carter Administration and the press have recently expressed optimism about prospects for the U.S. trade and current-account deficits in 1979 and 1980. U.S. manufactured exports are booming as a result of strong foreign growth and the enhanced competitive position of the dollar, while foreign demand for U.S. agricultural commodities is increasing as a result of supply constraints abroad. At the same time, the U.S. slowdown is working to depress non-oil imports.

The combination of these influences would indeed have produced an old-fashioned cyclical swing in the U.S. trade balance were it not for soaring oil imports. The steep oil price hikes are offsetting the export gains and weakened import demand to a large and growing extent. The value of oil imports for the second half of 1979, for example, is projected to rise some 45% above the year-earlier figure, with the promise of further price spiraling and market instability in 1980. All of this points to only a limited narrowing of the trade deficit—to $22-$23 billion in 1979, and to some $20-$25 billion in 1980.

U.S. external accounts

(balance-of-payments basis)



There is, however, some cause for optimism. The invisibles account is moving rapidly in favor of the United States, largely the result of higher earnings from direct U.S. investment abroad. The U.S. current-account deficit will accordingly shrink by roughly $10 billion this year to about $3 billion. And a further improvement of $6-$11 billion expected in 1980 will produce a *surplus* ranging between $3-$8 billion next year, the first surplus in four years.

The improvement in the U.S. current account is hailed by many as the potential curative for the dollar's ailments. However, the improving current account will fail to deliver in this regard, since much of the enhanced invisible-account earnings stem from net unrepatriated receipts from previous direct foreign investment. (These unrepatriated earnings account for about half of the projected improvement in the 1979 current account.) Since these earnings do not return to the United States, there is no commensurate demand for dollars in foreign-exchange markets to buoy the dollar. Thus, foreign-exchange analysts will probably focus on the more limited improvements in the trade balance in the foreseeable future as more accurate indicators of potential dollar strength associated with external-account movements.

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Spanish monetary restraint produces mixed results.

Spanish authorities are expected to maintain a relatively restrictive monetary policy throughout 1979, primarily to combat inflation. So far, the policy has had mixed results. While the year-on-year inflation rate fell to 15.9% for the first half of 1979, compared with 19.7% last year, capacity utilization is below its 1977 level, and investor surveys point to a likely continuation of the trend toward disinvestment. The investment weakness has resulted mainly from the recession in consumer expenditure, but also from the high cost of credit. With the balance of payments continuing in surplus and public-sector borrowing rising, credit to the private sector has been restricted. The resultant fall-off in economic activity has raised the unemployment rate to some 10%. On the positive side, weak domestic demand has fueled the export drive. For the first four months of 1979, exports were up 16.8% above the year-earlier level, while imports were up only 2.5%. Moreover, record capital inflows boosted the end-July reserve level to over $12 billion. The consequent demand for pesetas has continued to strengthen the peseta's exchange value, which rose by 6.4% against the SDR in the January-August period. While this has helped to control the money supply, it is likely to curb export growth for the remainder of the year and especially in 1980, when the added impact of a U.S. and European slowdown takes hold.

Denmark saddled with a nagging trade deficit.

While Denmark's recent election yielded small gains for the Social Democrats, the party still lacks a majority and is likely to form a minority government. The new government will face considerable problems, for although GDP growth has been buoyant, the inflation rate has accelerated and the trade balance has deteriorated. Consumer prices in August were 12.3% above the year-earlier figure, compared with 7% in January, and the cumulative trade deficit for the first eight months of 1979 was 13.7 billion crowns, versus 10.1 billion last year. Denmark's persistent trade gap, the country's most pressing problem, has saddled it with a net foreign debt of 65 billion crowns. Interest payments alone now account for some 6 billion crowns, or about one month's export revenues. A devaluation might seem the obvious course, but the Danish system of wage indexation would neutralize most of the benefits by aggravating inflation. Thus, government efforts will focus on the difficult task of winning agreement with the unions on removing import prices from the wage-regulating price index.

Inflationary pressures in Israel continue unabated.

Israeli inflationary pressures show no signs of abating. Over the last three months, prices have risen at an annual clip of 130%. Recent government measures announced to stem the rapid inflationary pace include a freeze on public-sector wages and a cutback on investment in industry to reduce the Government's borrowing needs and slow money supply growth. Private consumption, weakening because of accelerating inflation, the lagged response of wage indexation, and high borrowing costs, should slow further, since the impact of the restrictive measures has been only partially offset by the freezing of some prices. However, even if price rises slow substantially, the average year-on-year inflation rate for 1979 will still approach 75%. And since long-run policy is expected to remain growth-oriented, the long-term outlook is for continued high inflation.

Taiwan's export diversification efforts pay off.

Taiwan is successfully diversifying both its export products and markets. Leading the field in nontraditional exports are industrial machinery and basic metals, with exports of plastics and plywood following close behind. These developments are timely, as Taiwan's traditional exports—textiles and electronics—are feeling the drag of the U.S. slowdown. Exports to the United States were up only 11% in the January-June period, compared with the year-earlier level, implying a decline in real terms. Filling the market gap, however, were Hong Kong, West Germany, Saudi Arabia, and most importantly, Japan. Exports to Japan rose 60% during the first half of 1979, raising the Japanese share of total exports to 15.3% from 12.4% last year. In contrast, the U.S. share dropped from 41.7% to 35.8%. These changes signify substantial progress in redressing the politically-sensitive imbalances in Taiwanese trade with the United States and Japan. Overall, exports in the first half of 1979 were up 30% to $7.2 billion and imports were up 37% to $6.7 billion, suggesting a trade surplus of about $1 billion for the year. Thus, Taiwan appears to be well positioned to weather the current U.S. recession relatively unscathed.

Australia maintains priority on fighting inflation.

Curbing inflation remains a top priority of the Australian Government. Toward this end, the projected government budget deficit has been reduced to $2.5 billion for fiscal 1980 (July 1979-June 1980) from nearly $4 billion in FY 1979. The lower projection is based on the large increase in the excise duty on crude oil and the anticipation of higher personal income tax receipts, which are the result of a 1.5% tax surcharge in effect for the first half of the year. In addition, the target for money supply growth has been trimmed to 10% in FY 1980 from 12% in fiscal 1979. Upward pressure on consumer prices caused by sharp increases in petroleum costs will continue to work through the economy over the next several months, tempered somewhat by a downtrend in beef prices. Increased wage demands will also contribute to inflationary pressure. But the Government is committed to a more restrictive monetary stance and is willing to accept the consequence of slower growth. As a result, the inflation rate is expected to be held to about 10% in fiscal 1980, compared with 8.4% last fiscal year.

Venezuela's 1980 budget embodies conservative fiscal stance.

The Venezuelan Governments' budget for 1980 underscores the more conservative fiscal policy of the administration of President Herrera. In view of the large spending and debt rises of previous years, the 1980 budget proposes to reduce capital spending and limit current expenditure to only 14%—equivalent to the anticipated annual rate of inflation. Despite the sharp rise in oil prices realized this year, there is a heightened official desire for economic development to proceed more orderly and conservatively. Major capital projects are being scrutinized closely for efficiency and rates of return. The less expansionary budget comes in the context of an economy whose overall growth is progressing more slowly than last year because of fiscal and monetary restraints. As expected, the petroleum sector will see a rapid advance, but other sectors will record more subdued growth in line with policies aimed at bringing about an improved national spending and income balance.

Gabon's external accounts on steady path of improvement.

The improvement in Gabon's external accounts last year is carrying over into 1979. The 25% drop in the value of imports in 1978, traceable mainly to reduced public-sector spending, was largely responsible for widening the trade surplus by 40% to an estimated $790 million and boosting the current-account surplus from $42 million to $200 million. However, net capital outflows, attributable primarily to foreign debt repayment, left a mere $10-million surplus in the overall balance. This year, the recent increase in oil prices could boost export receipts an estimated 30%. Coupled with an import expansion of some 25%, this suggests a trade surplus of over $1 billion, with a corresponding widening in the current-account surplus to over $300 million. And although further substantial debt repayments are anticipated this year, the overall balance appears headed for a wider surplus, as reflected in a rising level of international reserves.

Free-market aluminum prices expected to weaken.

Despite economic weakness in the United States, world demand for aluminum has remained firm this year. Supply, however, has been curtailed by a three-month Alcan strike in Canada and reduced Japanese output. Production has been returning to normal since the early-September strike settlement, and the market has eased in recent weeks. As of August, free-market aluminum prices averaged about 76¢ per pound—27% above year-ago levels—while U.S. producer prices were held to the 60¢-63¢ range by the U.S. Government's voluntary price guidelines and "jawboning" of the big three producers. The start of a new U.S. guideline pricing period on October 1 has permitted further price increases; producer prices have risen to 66¢ per pound since then. Over the next year, free-market prices are expected to decline, with producer prices stabilizing at around current levels as a U.S. recession overlaps with a European and Japanese slowdown.

A Rebound, Not a Recovery

Statistical surprises announced over the past two weeks, including a larger-than-expected surge in GNP growth, have compounded the confusion over where we now stand in the current business cycle. Preliminary government estimates placed third-quarter real growth at 2.4%, a fairly hardy turnaround from the second quarter's 2.3% decline. Strong increases in retail sales and the stability of industrial production since the previous quarter lent support to the growth figures. But after discounting the statistics for the erratic behavior of the automotive industry, the recent display of strength is probably more indicative of an end-of-summer fling than of the future direction of the economy—particularly in light of the recent credit-tightening actions announced by the Federal Reserve Board.

Retail sales, for example, rose 2.2% in September on top of a heftily revised 3.1% increase in August. Special rebate and discount programs designed by domestic automakers to help move bulging inventories of 1979 models helped to boost sales. And the increased availability of gasoline induced consumers to make auto purchases postponed because of earlier gas lines. However, when adjusting these two large monthly gains for inflation, real sales are only slightly ahead of year-ago levels. Moreover, real disposable personal income is lower than it was at end-1978, despite a reduction in income taxes at the beginning of 1979. And consumer credit expansion slowed markedly in July and August. Thus, the ingredients needed to sustain the recent strength are absent.

Business inventory policy is another sign of the hollowness of the rebound. The book value of manufacturing and trade inventories in August grew 0.8%, the smallest monthly rise this year. The relatively moderate rise followed July's huge 1.9% growth in inventory accumulation. The moderation was welcome, since excessive inventory levels eventually trigger cutbacks in production and higher unemployment. In fact, industrial production declined 0.9% in August. But it rebounded 0.5% in September, mostly the result of a 5% jump in auto output. Few industry observers expect Detroit's upturn to be sustained, however, and auto production is scheduled to taper off in the fourth quarter.

Declining sales and the fear of excessive inventory accumulation will lead to a cautious inventory policy in the coming months. And the recent Fed actions will reinforce the incentives for such an approach, since inventories become increasingly expensive to carry as interest rates are pushed higher. Coupled with the anticipated slowdown in consumer spending, the reduced inventory investment should unambiguously herald a true recession in early 1980.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALANCE OF			
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered
Argentina	Decreasing rate of monthly peso devaluations being maintained through March 1981.	Mar.	+ 15%	55.0	$2,076	June	7,717	+ 55%	23.6
Barbados	New five-year industrial development plan aims at attracting manufactured export industries.	Jan.	— 13%	0.5	1,984	Aug.	79	+ 53%	2.8
Brazil	Government encouraging purchase and production of alcohol-powered vehicles to cut oil imports.	Apr.	+ 14%	190.9	1,654	June	10,110	+ 25%	7.7
Chile	Austerity in public sector introduced in effort to moderate inflationary pressure.	June	+ 53%	15.6	1,440	July	1,583	+ 63%	5.6
Colombia	Foreign investment rising sharply as companies already present reinvest "limbo funds."	May	+ 19%	23.1	895	Aug.	3,472	+ 67%	15.3
Costa Rica	Revised official statistics put real GDP growth at 5.9% in 1978, down from 7.7% in 1977.	June	— 21%	3.5	1,650	Aug.	77	— 68%	0.7
Dominican Rep.	Productive activity sharply curtailed as consequence of severe hurricane damage.	June	+ 4%	4.4	860	Aug.	152	+ 45%	1.8
Ecuador	Large new budget allocations based on increased taxes and improved collection.	Apr.	+ 19%	7.2	924	Aug.	708	+ 7%	5.1
El Salvador	President Romero ousted; new leaders seek moderate and nonviolent national solutions.	June	+ 5%	6.3	942	Aug.	293	+ 83%	3.4
Honduras	Economic slowdown expected this year as tighter liquidity hinders investment expansion.	Apr.	+ 20%	1.7	570	June	190	— 19%	3.2
Mexico	Inflation rate rises to 20% annual pace as money supply expands strongly.	June	+ 50%	92.8	1,386	May	2,011	+ 15%	2.5
Nicaragua	War damage to productive sectors estimated at $480 million; agriculture has reconstruction priority.	Mar.	+ 19%	2.4	995	Dec.	51	— 66%	0.8
Panama	Panama assumed control over much of Canal Zone on October 1, as new treaty became operational.	Mar.	— 29%	3.4	1,868	May	113	+ 8%	1.4
Peru	Real GDP estimated to have grown 3% in first half of 1979 after several years of decline.	June	+ 187%	10.7	640	July	651	+ 80%	5.1
Puerto Rico	U.S. recession and hurricane damage have adverse impact in form of lower output and higher prices.	July	+ 17%	8.8	2,650	Aug.	7,713°	+ 16%	12.8
Trinidad & Tobago	Crude oil exploration efforts stepped up to augment declining production of old wells.	May	+ 5%	3.6	3,215	Aug.	1,797	+ 10%	12.0
Uruguay	Both economic expansion and inflation rate exceeding targeted levels.	Mar.	+ 25%	5.0	1,590	May	825	+ 67%	14.0
Venezuela	New 1980 fiscal budget aims at limiting spending growth so as to restore balance to economy.	May	+ 21%	41.2	3,150	July	5,865	— 18%	8.8

Commercial bank deposits

Bond Market Plagued By Uncertainty

Bond market participants are still in shock from the market's adverse reaction to the Federal Reserve's October 6 policy move and the spate of unfavorable news in its wake. Since the Fed's announcement, the prices of long-term (greater than 20-year-maturity) Treasury bonds have plummeted about 8% on average—a decline unprecedented in recent times for such a short period. The drop in the prices of low-rated corporate bonds was even more precipitous.

This sharp decline startled a number of analysts—and probably the Fed as well. The primary purpose of the Fed's actions—especially its announced intention to place greater emphasis on controlling the supply of bank reserves—was to reduce future inflation. And since inflationary expectations are a major determinant of bond yields, a moderation in such expectations should, other things being equal, have a *downward* impact on bond yields, or equivalently, an *upward* impact on bond prices.

A major reason for the strongly adverse effect of the Fed's announcement on bond prices has undoubtedly been rising uncertainty. It is still unclear how the new policy will actually affect the Fed's operating strategy. Nor is it clear how long the new policy of focusing on the supply of bank reserves will continue. Moreover, there is a growing fear that a "credit crunch" may be at hand—i.e., a period of credit-market dislocation during which non-price credit rationing is widespread, and credit availability to certain types of borrowers is curtailed regardless of interest rates paid. Finally, there is increased doubt over the near-term outlook for the U.S. economy. In sum, uncertainty has prompted many investors to stay out of the bond market until the Fed's intentions can be more accurately assessed and the economic outlook becomes clearer.

It is also uncertain how the Fed views the recent chaotic conditions in the bond market. In the past, one of the major objectives of the Fed has been to foster "orderly" market conditions. Thus, some analysts feel that if the wide fluctuations in bond prices continue, the Fed will consider steps to stabilize the market.

One may take the view, however, that a sense of instability in financial markets will contribute to the anti-inflation program undertaken by the Fed. For example, some economists believe the only effective way to slow inflationary momentum is to trigger a credit crunch and thus curb spending. From this perspective, since the so-called "gradualist" policy of the Fed during most of 1979 failed to contain inflation or money and credit growth, a financial shock was needed to slow money growth and thus check inflation. Recent statements by Fed officials, however, suggest a concern about the recent conditions in financial markets, and efforts have been made to allay crisis sentiment.

AYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
MF nil- ollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	October 24, 1979		current monetary conditions	
	Overvalued currency spurs higher spending on tourism and imports.	May	+ 153%	May	+ 170%	18.00%	.00071	Cut in banks' minimum reserve ratio.	Argentina
	Income from tourism rose 22% in 1978.	July	+ 13%	June	+ 7%	—	.5200	Bank deposits up sharply in January-March 1979.	Barbados
	Cruzeiro mini-devaluation pace accelerated.	May	+ 46%	May	+ 49%	33.00%	.0340	Monetary authorities want interest rates reduced.	Brazil
	Steady reduction in tariffs—10% with some exceptions—spurs import rise.	Aug.	+ 35%	Dec.	+ 58%		.0270	Central Bank encouraging greater banking competition.	Chile
	Coffee exports totaled a record $2.1 billion in fiscal 1979.	May	+ 23%	May	+ 17%	20.00%	.0270	Tight liquidity conditions prevail.	Colombia
	End-August official reserves down 60% to $77 million from end-1978.	June	+ 8%	May	+ 43%		.1200	Increased liquidity.	Costa Rica
	Grim outlook for external sector owing to reduced FX-earning capacity.	Apr.	+ 5%	Mar.	+ 14%	—	Par	Demand for credit up sharply.	Dominican Rep.
	Manufactured exports show strong rise.	June	+ 12%	May	+ 36%	8.00%	.0400	Large increase in bank loans.	Ecuador
	Controls imposed to stem foreign-exchange outflows.	June	+ 7%	July	+ 2%	—	.4030	Increased capital flight.	El Salvador
	Official reserves as of June down 19% from year-earlier level.	July	+ 9%	Apr.	+ 17%		.5015	Monetary policy restrictive.	Honduras
	Mexican oil price raised to $24.60 per barrel.	June	+ 18%	May	+ 30%	4.50%	.0445	Bank deposit rates increased.	Mexico
	State-run company created to control principal exports and imports.	Sept '78	+ 4%	Apr.	+ 45%	—	—	High-denomination bank notes removed from circulation.	Nicaragua
	International banking sector grows rapidly.	Apr.	+ 7%	June	+ 8%	—	Par	Strong deposit and credit creation since end-1978.	Panama
	All financial restrictions on imports lifted.	Apr.	+ 80%	Apr.	+ 53%	—	.0043	Stiff marginal reserve requirements imposed.	Peru
	Tourism down in August-September period.	Aug.	+ 6%	Aug.	+ 9%	29.50%	1.00	Loan growth declines from previous high rate.	Puerto Rico
	Trade surpluses widened in April-May period.	June	+ 12%	Apr.	+ 26%		.4300	Bank liquidity ample.	Trinidad & Tobago
	Tariff barriers reduced on wide range of clothing and foodstuffs.	June	+ 63%	Dec.	+ 71%	—	.1250	Interest rate ceilings lifted.	Uruguay
	Higher oil prices to produce 1979 trade surplus.	June	+ 10%	May	+ 33%	8.50%	.2335	Bank liquidity declined in August.	Venezuela

World Interest Rates

market rates of October 24, 1979; bond yields as of October 19, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00*	14.00	10.00	9.50	5.00	12.00 penalty rate 15.00	8.00	1.00	5.25
Day-to-Day Money	14.50 Oct. 25	13.25	14.25	10.95	11.50	8.10	12.50	8.75	1.75	6.9375
Treasury Bills 91-day, Middle Rates	12.70	12.70	13.3125	13.75 120-day	n. a.	n. a.	11.85 99-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	12.875 finance paper	14.00 finance paper 15% tax w/h	12.95 H. P. on discount basis	9.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.35	14.00 15% tax w/h	13.875	12.00 Certified	not traded	7.40	n. a.	no market	3.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.08	11.50	12.67	9.24 20% tax w/h	10.44	7.80	13.39	8.84	3.50	7.89
Industrial Bonds prime, long-term, new and old issues, average yield	10.75 Aa Industrials	12.00	13.05	12.25 20% tax w/h	11.84	7.90	13.78	9.36	4.70	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.00	14.75*	15.00	14.00	10.10	7.25	17.00	11.50	4.00	5.50
Bank Time Deposits 3-month	14.00 Cert. of Dep	13.75 Cert. of Dep	14.375 Cert. of Dep	14.20	12.625	8.85	10.00	10.00 large deposits	3.4375 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	15.50	no market	14.25	no market	13.625	8.5625	no market	9.62[illegible]	3.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8455	2.1150	.034575	.2369	.5547	.001201	.4996	.6044	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.125 *P*	.50 *P*	1.625 *P*	1.75 *P*	6.75 *P*	1.375 *D*	6.00 *P*	12.50 *P*	7.375 *P*

Eurodollar Deposits

(London, interbank, bid)
October 25

7-day	16.25
1-month	15.25
3-month	15.5625
6-month	15.3125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .93
U.S.-Canada Treasury Bills	− .57
U.S.-Canada Finance Co. Paper	−2.06
Eurodollars-U.K. Local Auth. Deposits	+1.00

Eurobonds**

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.25
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	7.625
Over 7 yrs.	7.75

Gold Price

London
afternoon fixing

395.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

*Rates as of Oct. 25. **Eurobond rates as of Oct. 17.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.8 (Aug.)	9.6 (Sept.)	16.5 (Sept.)	10.8 (Aug.)	4.9 (Aug.)	15.5 (Aug.)	4.8 (Sept.)	3.1 (Aug.)
Industrial production*	2.5 (Sept.)	−0.1 (Aug.)	−4.0 (Sept.)	5.5 (Aug.)	5.1 (Aug.)	3.7 (July)	−3.0 (June)	8.9 (Aug.)
Trade balance† *(billions of local currency units)*	−$2.4 (Aug.)	−C$.141 (Aug.)	−£.100 (Sept.)	−FF1.79 (Sept.)	DM.98 (Aug.)	Lt583 (Aug.)	−SF.445 (Sept.)	−¥163 (Sept.)
Money supply (M_1)*	4.7 (Sept.)	6.2 (Sept.)	12.4 (July)	12.3 (July)	11.1 (Aug.)	22.8 (May)	13.8 (July)	11.1 (Aug.)
Velocity of money (M_1)*	6.6 (June)	5.4 (June)	−4.0 (Dec.)	n. a.	−3.1 (Mar.)	−5.6 (Dec.)	n. a.	−4.0 (Mar.)
Reserves *(millions of U.S. $, end of period)*	20,907 (Aug.)	4,276 (Aug.)	20.901 (Aug.)	19.608 (July)	51,785 (Aug.)	22.674 (Aug.)	17,138 (Aug.)	25,475 (Aug.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

Italian Economy Makes Structural Progress

Beginning with the formation of the EEC in 1958 until the oil crisis of 1973, Italy's economy registered one of the highest growth rates in Europe—4.9%. Foreign trade expanded more than twice as fast as GDP, gross investment averaged about 21% of output, and the current account remained roughly in balance.

In the early 1970s, however, several structural problems emerged. First, Italy's total lack of domestic raw materials left it vulnerable to world commodity price increases. This was particularly apparent in the wake of the 1973/74 oil price hike when Italy was importing 82% of its primary energy. Second, wage indexation prevented a downward adjustment in real wages in response to the oil price shock, so that the entire burden of adjustment fell on profits and employment, leading to a decline in investment relative to GDP. Third, Italy's public-sector borrowing requirement (PSBR) accelerated, both for demographic reasons and because the Government was forced to subsidize investment, employment, and unemployment. The large and growing PSBR forced policymakers to choose between inflationary financing of the PSBR (i.e., printing money) and crowding out the private sector. Finally, Italy's money and capital markets were relatively undeveloped, making it difficult to finance its current-account deficits.

The combination of these structural problems resulted in a marked cyclicality of policy and economic performance in the 1970s. Economic upswings led to rapid monetary growth, rising inflation, and a large balance-of-payments deficit. This was countered by tight monetary policy, a crowding out of private investment, an economic downswing, and an external payments surplus.

Italy's structural deficiencies have been remedied to some extent. Dependence on imported energy was cut from 82% in 1974 to 78% last year, and Italy's energy-consumption-to-GDP ratio was reduced from 1.07 in 1974 to 1.04 in 1978.

More importantly, Italy has sharply increased its share of world exports since 1974, largely because of its improved international price competitiveness and reduced profit margins in domestic markets. Export volume grew 38% during the 1974-1978 period, compared with growth in world trade volume of only 16%.

Another structural change evident since 1974 has been a broadening and deepening of Italy's money and capital markets, facilitated by large issues of government debt to finance the PSBR. The more mature financial markets ease the financing of any future Italian current-account deficits because they provide greater scope for autonomous financial investment in Italy.

Two major structural problems persist, however: the growing PSBR and wage indexation. Public spending, particularly on transfer payments, continues to grow rapidly, expanding the PSBR even relative to GDP, despite improvements in tax collections. As wage indexation is expected to remain in force for another three years, the latest oil price rises will have to be financed out of profits and employment, barring an unforeseen acceleration in productivity. This suggests a further decline in real investment relative to GDP.

Italian monetary and fiscal policies were highly expansionary last year. The PSBR amounted to some 14.5% of GDP, and the broad money stock grew roughly 23%, or over 10% in real terms. As a result, economic activity was particularly intense in the fourth quarter of 1978 and continued brisk through the first quarter of 1979. While labor unrest has distorted the more recent statistics, underlying economic growth appears to be slowing.

Italy's inflation rate in 1978 stabilized at the 12% level, as domestic inflation was masked by the weakness of the U.S. dollar, which held lira import price rises to only 4.5%. As the dollar stabilized in late 1978, however, the inflation rate accelerated to a 17% annual rate in the first eight months of 1979. An even more rapid rate may be expected for the remainder of the year. The 1979 PSBR is expected to reach some 38 trillion lira, and nominal money supply growth continues to exceed 20%. Furthermore, the recently-completed, three-year national wage negotiations left the wage indexation system virtually intact. It is estimated that real wages will increase some 3% on an average annual basis over this period.

On the external front, Italy posted a record $6.2-billion current-account surplus in 1978, the second largest in Europe. In volume terms, export growth exceeded import growth (11.4% versus 8.7%) and terms of trade improved by some 2.5%, thanks to the dollar's weakness. For this year, the combination of rapid Italian growth, accelerated stockbuilding, and the impact of sharply higher oil prices is likely to halve Italy's current-account surplus to the $2.5-$3.0-billion range. A sharp slowdown in world trade expected for 1980 should lead to a balanced current account. However, another rise in oil prices or more expansionary Italian economic policy could tilt the current-account balance into deficit. (The 1980 budget proposals recently submitted to Parliament incorporate a PSBR of some 40 trillion lira. However, Parliament may still substantially modify the package.)

Italy's underlying rate of growth is expected to slow in the second half of 1979, mainly because of weakening real investment. The official forecast is for real GDP growth of over 4% for the year as a whole, with economic growth expected to slow to some 2.5% in 1980. Even this figure may prove overly optimistic, given the expected deceleration in world trade volume and the more restrictive monetary policy that will be necessary to contain inflation and protect the lira.

George de Nemeskeri-Kiss, Chase London

Tracing Eurocurrency Market Growth

The Eurocurrency market has grown rapidly in almost every year since its inception. Last year was no exception, with the gross size of the market increasing by some 30%. In the first half of 1979, however, growth slowed to an estimated 10% annual rate, partly the result of the dollar's stability during this period. (Since the Euromarket is measured in dollars, a substantial dollar depreciation, such as occurred in 1977 and 1978, triggers a rapid appreciation in the dollar-value of the non-dollar component of the Eurocurrency market.) The slower growth in first-half 1979 also reflects the implementation of tighter monetary conditions worldwide.

In projecting Eurocurrency market activity in 1980, a variety of factors must be considered. Of particular importance are: the trends in world monetary conditions and inflationary prospects; the general performance of the dollar in foreign-exchange markets; the growth of world trade; the new marginal reserve requirements in the United States; and the world impact of the OPEC price hikes.

The current trend in world monetary conditions is toward higher short-term interest rates as a means of curbing future inflation. Such policies are now being pursued in both the United States and Germany, and they will tend to depress overall Eurocurrency market growth. Also, U.S. authorities have indicated an increased willingness to defend the dollar against a major depreciation. This makes unlikely the extremely rapid expansion of Eurocurrency market size that another round of general dollar depreciation would engender. Another factor favoring slower Eurocurrency market growth is the projected slowdown in the growth of world trade in 1980.

Offsetting these factors, the sharp hikes in the world oil price and the resulting OPEC surpluses will have a major impact on Eurocurrency market growth. First, the Eurocurrency market will capture a large share of OPEC short-term funds. And second, countries in deficit positions will be forced to turn to the international capital markets for balance-of-payments funding. Also supportive of rapid growth are the new monetary regulations introduced in the United States that require domestic U.S. banking offices to hold 8% marginal reserves against managed liabilities. This provides an increased incentive for U.S. banks to book foreign loans in offshore markets.

On balance, the growth of the Eurocurrency market is likely to pick up rapidly in the second half of 1979 —to an annual pace comparable with that of 1978— and then drop to approximately a 20% rate in 1980. Accordingly, the gross size of the market could exceed $1 trillion dollars by late 1979, and could reach $1.3 trillion by end-1980.

It is well known that the gross size of the market is an overstated indicator of loan growth because of significant double-counting of bank positions; however, even the net size measures contain sizable bank and official transaction components. Thus, actual lending to private nonbanks is perhaps the more revealing measure. Such loan activity is expected to grow much more slowly, by about 10% in 1980, following 15% growth estimated for 1979. Lending to public authorities, which grew less than 15% in the first half of 1979, should accelerate in 1980, very possibly to 40%.

As a final note, the share of Eurocurrency lending captured by U.S. banks may rise in 1980 for several reasons. First, the negative impact of a depreciating dollar will be absent, or at least much less significant than in past years. Second, certain competitors, particularly the Japanese banks, may be less active. And third, the impact of the new U.S. marginal reserve requirements will provide profit incentives for U.S. banks to turn to the international markets.

Bluford H. Putnam

Eurocurrency Market

($ billions, end of period)

	IIIQ/78	IVQ/78	IQ/79	IIQ/79	1978	1979 (est.)	1980 (est.)
Total Market Size							
Gross Size (Claims)	793.5	892.1	882.6	935.0	892.1	1.075.0	1.300.0
Net Size (Claims)	495.0	535.0	545.0	575.0	535.0	650.0	780.0
Liabilities to Private Nonbanks	125.0	140.0	145.0	155.0	140.0	170.0	205.0
Claims on Private Nonbanks	260.0	280.0	285.0	295.0	280.0	320.0	360.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	245.8	259.9	272.9	295.8	259.9	315.0	380.0
Liabilities to Private Nonbank Foreigners	51.8	57.8	57.6	60.5	57.8	72.0	87.0
Total Claims on Foreigners	293.2	322.8	315.1	328.4	322.8	355.0	430.0
Claims on Foreign Public Borrowers	31.9	33.8	35.7	36.0	33.8	40.0	55.0
Claims on Foreign Private Nonbank Borrowers	99.7	104.3	103.5	107.7	104.3	120.0	135.0

Note: *Gross* and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the Eurocurrency interbank component. Net size includes transactions between banks in the Euromarkets and: (a) official monetary authorities; (b) banks not participating in the Eurocurrency market; and (c) nonbanks.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.

CHASE

International Finance

Vol. XIV, No. 22
November 12, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

International Reserve Currency Options

The dollar's continuing decline as the key international reserve currency has emerged as a major preoccupation of world financial experts. This was underscored at a conference on "Achieving Stability in the International Monetary System", held in Philadelphia on Oct. 31–Nov. 1 under the auspices of the Global Interdependence Center. At the conference, attended by leading authorities on the world payments system, the question of alternatives to a dollar reserve currency emerged as a recurring theme.

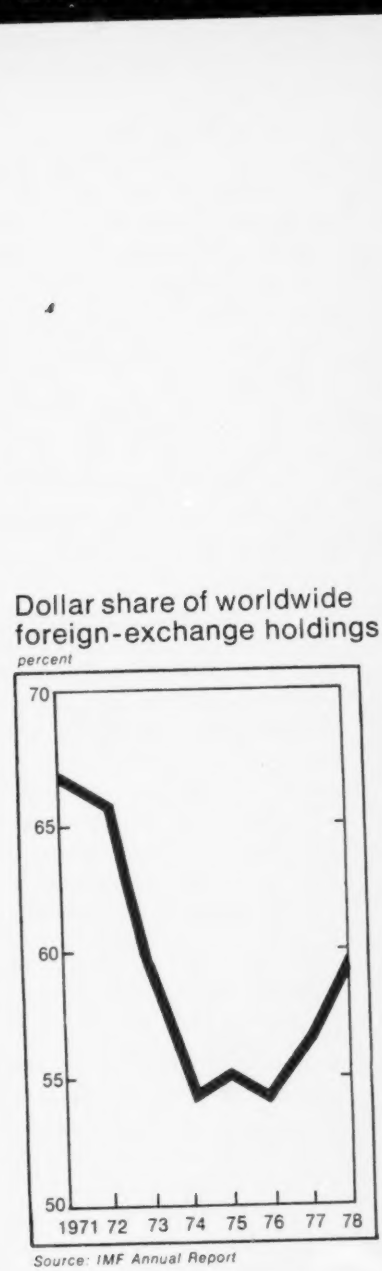
Although the dollar remains a major reserve currency, conference participants widely acknowledged the inevitability of the trend toward international currency portfolio diversification on the part of the world's money managers. The key question was whether there are more stable alternatives to either the dollar-reserve or the multiple-reserve currency systems.

The trend toward a multiple-reserve currency system has evolved despite the reluctance of the new key countries–e.g., Germany, Switzerland, and Japan–to face the inherent conflict of accommodating domestic monetary policy with the imperatives of reserve-exchange-rate management. Worldwide decisions to diversify have reflected irreversible market forces, including changing world trade patterns, increasing demand by developing countries for non-dollar key currencies as pegs, the rise in non-U.S. sources of debt, a relatively less important U.S. presence abroad, and concern over possible dollar weakness in the future.

The conferees generally conceded that a multiple-reserve-currency scheme may indeed be the only feasible course. A reconstituted dollar-reserve role was viewed as unlikely unless the United States could once again achieve high rates of real growth and productivity with low monetary expansion, maintain positive real interest rates, and keep a tight rein on the foreign-exchange markets. Conference participants were divided as to the practicality of reserve-currency status for the SDR. However, all agreed that this would necessitate acceptance and dissemination of the SDR by both official and private financial managers, and require a major revamping of the IMF to give it the powers of a world central bank.

Not only is the evolving multiple-reserve currency system the most pragmatic route for the near future, in the view of many conference participants, but it may also be the best way to enhance international monetary stability. It has already entailed increased monetary cooperation and economic policy harmonization among its key sponsors, as evidenced by such initiatives as the EMS and the new U.S. monetary stance.

Dollar share of worldwide foreign-exchange holdings



Source: IMF Annual Report

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Canadian economy in downswing, but export growth is strong.

Canada's economic prospects are for slower GNP growth, continuing high inflation, and a larger balance-of-payments deficit, with possible declines in unemployment. The economy is in a downswing, with real growth at only 1% during the first half and inflation at more than 9%. The current-account deficit is likely to widen to C$7 billion in 1979 after a C$5.3-billion deficit last year. The unemployment rate, however, has declined from 8.5% in 1978 to just over 7% in recent months, a partial consequence of slower labor force growth. Also bolstering employment is the decline of the Canadian dollar, which has spurred substantial export growth and has led to higher operating rates in some key industries. Investment has also been strong because of the higher capacity utilization rates, and it is preventing aggregate demand from slipping too sharply. Nevertheless, the drag of the U.S. recession is expected to hold total real GNP growth below 2% in 1980, compared with estimated growth of 2.5% this year.

German monetary policy continues anti-inflationary.

In the weeks following the Volcker package announcement, the German Bundesbank allowed German money market rates to rise above 9%, reflecting strong seasonal reserve demand by the banking system. It recently consolidated interest rates by raising the discount and Lombard rates by one percentage point to 6% and 7%, respectively. At the same time, it raised bank discount quotas by 5 billion DM. While the latter move is designed to prevent an over-tightening of rates in view of the forthcoming DM 2 billion Carter bond issue, the overall stance of monetary policy remains highly restrictive. Central bank money, the Bundesbank's target money stock, has grown at a seasonally adjusted annual rate of only 2.8% in the third quarter and looks set to achieve the lower end of the 6%-9% target range for 1979. The reason for the restrictive stance is the fear that the current year-on-year inflation rate of 5.7% will be incorporated into this winter's wage settlements, thus internalizing what was essentially imported inflation. Once the wage negotiations are settled, weaker real growth and the inability of monetary policy to affect wage costs are likely to lead the Bundesbank to a more relaxed monetary stance.

Swiss economic policy focused on reducing monetary growth.

Swiss economic policy in 1979 has been aimed at reducing progressively the high monetary growth caused by heavy speculative inflows into francs at the height of last autumn's dollar crisis. The authorities have been reluctant to pursue an excessively restrictive monetary policy, however, for fear of provoking further upward pressure on the exchange rate and damaging the economic recovery underway since the start of 1979. By all accounts, the policy has succeeded. The economic recovery is expected to continue into the fourth quarter, and inflation has decelerated. (The annualized inflation rate for the June-September period was only 2%.) However, the export-weighted index of the exchange rate is now 20% lower in real terms than its peak of September 1978—good for exports, but a concern for Swiss authorities highly sensitive to the inflationary implications. Nevertheless, the dollar's recovery since the announcement of the new U.S. monetary policy has given the Swiss room to reduce liquidity further. Given the outlook for higher interest rates in both Germany and the United States, it seems unlikely that interest rates have yet reached their peak in Switzerland.

Ireland paying the price of an independent currency.

While Ireland's economic performance continues strong, signs point to a downward revision of the country's ambitious growth plans. The rapid growth of the last 18 months has led to a severe deterioration in the balance of trade. The balance registered a deficit of $300 million in June, bringing the cumulative first-half deficit to $1.6 billion, compared with $800 million a year earlier. A further problem stems from the soaring budget deficit, which is now running at well over $1.5 billion per annum, and which has triggered inflationary increases in the money supply. When Ireland shared a common currency with Britain, budget and balance-of-payments deficits had little impact on the Irish economy as they were insignificant relative to the large British economy and its currency. With the Irish currency de-linked from sterling, such deficits now have a large impact on the Irish pound. As a result, the Government has been forced to introduce a tight squeeze on domestic credit, which should bring this year's GDP growth down to some 4%, versus 7% in 1978—with the threat of an even greater growth reduction in 1980.

An export bonanza for Indonesia.

Windfall earnings from soaring oil and commodity prices this year have spawned an export bonanza far beyond the highest hopes of Indonesia's economic planners when they devalued the rupiah 33.6% last year. Both oil and non-oil exports are expected to increase in value by at least 25% during the current fiscal year ending March 1980, while imports should grow more moderately. Gross oil and LNG earnings are likely to reach $9.5 billion this year, up from $7.6 billion in FY 1978/79. Non-oil commodity export earnings should add another $5 billion, and manufactured exports will also post impressive gains. Overall, total export earnings will be at least $14 billion this year, compared with $11.5 billion last year. And with imports estimated at $11-$12 billion, the trade surplus should reach a minimum of $2 billion. Government planners now face the enviable task of disposing of the sudden infusion of foreign-exchange reserves. It is expected that they will opt for prudence, rather than a spending spree reminiscent of 1974.

Singapore's high wage policy will boost inflation.

Singapore's inflation rate looks set to rise sharply this year. The largest boost to prices will stem from the July recommendation of the National Wages Council for an average 20% wage hike for 1979 and possibly 1980, as compared with previous annual increases below 10%. The high wage policy hopes to promote more technologically advanced production methods and an upgraded labor and management force, but is expected to add two percentage points to inflation in 1979. In addition, the effects of oil price rises in the first half of 1979 are now being felt, as is the increased cost of imports associated with higher inflation in nearly all Singapore's trading partners. Overall, these influences are expected to increase Singapore's inflation rate to nearly 8% in 1979, versus 4.8% last year, the highest in five years, but still one of the lowest in Asia.

Argentine economy showing signs of strength, despite high inflation.

The level of Argentine economic activity continues high, with strong advances in construction and consumer spending. August industrial production was 21% above the year-ago period, and auto production has been especially strong this year. Real GDP for first-half 1979 rose 11% over first-half 1978, and the labor unemployment rate was only 1.5% in July 1979. In the external sector, both exports and imports are setting record levels, and capital inflows are strong. This despite a still high inflation rate that has averaged 164% for the first three quarters of 1979. In an effort to reduce inflationary expectations, the monthly rate of peso devaluation is being pegged well below the inflation differential between Argentina and the industrial countries. This policy has sparked considerable opposition from exporter groups and import-competing industries. Thus far, however, the Government has resolutely upheld the exchange policy as a means of promoting economic efficiency and competitiveness and curbing future inflation.

Mild cyclical decline in rubber prices anticipated.

A projected decline in auto sales is expected to lead world consumption of natural rubber next year to fall short of production for the first time since 1976. As demand softens and inventories rise, natural rubber prices, currently about 17% above year-ago levels, should fall. The extent of this cyclical decline, however, is likely to be considerably less than in the 1973-74 downturn because of: (1) a milder recession in the United States and less economic weakness abroad; (2) a continued rise in the costs of synthetic rubber feedstocks, as OPEC acts to head off another oil glut; (3) a shift toward radial tires, which require a higher proportion of natural rubber relative to synthetic than bias tires; and (4) the expected ratification of last month's International Rubber Agreement. Although the IRA does not take effect until Oct. 1, 1980, ratification would probably encourage stockpile building before then if prices drop to the low end of the agreed-upon range.

Consumer Credit Growth Soars in September

Consumer instalment credit rose by a record $4.45 billion on a seasonally adjusted basis in September, according to a recent Federal Reserve Board release. This rapid growth—which sharply exceeded that in the three preceding months—represents a combination of a 3.8%-increase in credit extensions and a 3.8%-decrease in liquidations of existing debt. It is doubtful, however, that consumer credit—or consumer spending—will continue increasing at such rapid rates during the remaining months of 1979.

The surge in consumer credit reflects to a large extent the surprising strength in consumer spending in August and September. For example, retail sales during this two-month period increased at an annualized rate of 37%, far outstripping personal income growth. To some extent, the recent strength reflects a catch-up from the depressed spending levels of the preceding months, during which gas shortages were widespread.

This is especially noticeable in auto sales. Spurred by price rebates and increased gas availability, car sales in August and September rose sharply from the previous two months. This increase was reflected in the $1.8-billion rise in instalment credit used to finance auto purchases in September. October car sales, however, fell 15% on a seasonally adjusted basis from September, and most analysts expect continued weakness. It is likely that consumer borrowing for auto purchases will reflect this decline, and this should depress consumer credit growth.

Furthermore, the September surge in consumer credit preceded the Fed's October 6 credit-tightening announcement and the subsequent large jump in interest rates. The increased cost of borrowing in states in which consumer loan rates are permitted to rise with market rates has made such loans less attractive to borrowers. The rise in interest rates has also made usury ceilings in several states binding, and this could sharply curtail consumer credit growth in these states.

Consequently, consumer credit growth in the fourth quarter should be well below the 18% annualized growth rate registered in September. This does not necessarily mean, however, that consumer credit growth will turn negative in the next few months. Even if new credit extensions begin to slow down somewhat, liquidations of existing debt may decline even further as consumers delay loan repayments. Indeed, some analysts have pointed to the sharp drop in liquidations in September as evidence that some borrowers may be having difficulty repaying past loans. While it is too early to jump to such a conclusion, problems arising from high consumer debt burdens may indeed materialize when a significant slowdown in the economy and a sharp rise in unemployment occur.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALAN				
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered	li
Africa	**Algeria**	Authorities plan to export less crude oil and more refined petroleum in 1980.	July	+ 62%	19.3*	$ 1,075	Aug.	2,296	+ 58%	4.0	
	Egypt	Actual public investment outlays in 1979 expected to exceed budget target of $3.7 billion.	May	— 25%	18.8*	484	July	438	— 22%	1.5	
	Ethiopia	All maritime transport and transit services nationalized.	Mar.	+ 2%	3.7	125	Aug.	156	— 16%	4.2	
	Ghana	Government takes drastic measures to combat cocoa disease.	n.a.	n.a.	14.3*	135	Aug.	336	+130%	4.0	
	Liberia	High rubber prices trigger rehabilitation and expansion of plantations.	Dec.	+ 10%	0.7	428	Aug.	22	— 44%	0.6	
	Libya	Beginning 1980, crude oil sales to foreign companies not investing in Libyan exploration will be reduced.	June	+ 50%	17.5*	6,635	Sept.	5,164	+ 18%	10.5	
	Madagascar	Increased foreign borrowing directed to productive investment in agriculture and industry.	June	+ 5%	2.0	240	Feb.	28	— 68%	0.8	
	Morocco	Investment in industry fell 25% during first half, compared with the year-earlier period.	Apr.	+ 16%	9.1*	497	July	640	+ 29%	2.5	
	Nigeria	Supplementary budget boosts federal allocations by $3.3 billion, reflecting higher oil revenues.	July	+ 85%	41.4	520	Aug.	4,103	+118%	4.5	
	Sierra Leone	Hosting of 1980 OAU Conference diverts funds from agricultural development.	June '78	+ 35%	0.9	220	Aug.	33	— 15%	1.7	
	South Africa	Fiscal and monetary policies emphasize growth rather than inflation-control.	June	+ 40%	45.7	1,650	Aug.	921	+ 7%	1.4	
	Tanzania	Producer prices for export crops raised 20%-25%.	Dec.	— 1%	3.4*	213	June	100	— 47%	1.3	
	Tunisia	Three contracts awarded for expanding phosphate complex at Gabes.	June	+ 34%	5.8	936	Sept.	446	+ 18%	2.6	
	Zambia	Disastrous 1978/79 harvest causes serious maize shortage; food crisis feared.	Dec.	— 8%	2.8	512	July	104	+ 25%	2.0	
Middle East	**Iran**	Recent political turmoil confuses status of oil exports to the United States.	July	— 2%	76.4*	2,227	May	10,814	— 13%	7.5	
	Kuwait	Kuwait considering substantial oil production cut next year.	July	+ 73%	12.6**	11,850	Aug.	2,835†	— 6%	7.4	
	Saudi Arabia	Direct exports of crude rising steadily as a proportion of total sales.	July	+ 38%	13.2*	17,820	Aug.	1,002†	+ 23%	3.3	
	United Arab Emirates	Government development outlays continue to favor infrastructure and hydrocarbon industry.	July	+ 50%	57.0**	7,130	Aug.	17,373†	— 10%	8.8	

*1977 **FY 1976/77 †Excluding State reserves

Inflation: When Will the Cure Take Effect?

Perhaps the most frustrating aspect of the Federal Reserve Board's new inflation-fighting strategy is the inevitable lag between its initiation and the first concrete sign of its success. Economists caution that patience is critical, pointing out that it could take many months before the new policy brings about an abatement in inflation. And unfortunately, the latest reports of persistent hikes in both consumer and producer prices have only increased anxiety further.

The Consumer Price Index rose a seasonally adjusted 1.1% in September, a heady 14% annual rate. A continuation of the trend established so far this year would make the 1979 price rise the worst since 1946, when the removal of World War II price controls sent prices soaring. Producer prices in October provided little hope that the retail price surge will ease substantially in the near future. The finished goods index climbed 1.0% on top of a 1.4%-increase in September. Although the October figures reflected some moderation in the rate of increase of energy prices and a slight decline in food prices, the costs of other finished goods increased markedly, suggesting a more broadly based inflation problem.

How soon the inflation statistics will begin to reflect the Fed's credit-tightening policies is not known. There remains a good deal of mystery, as well as controversy, about the links between the supply of money and credit, inflation, and economic activity.

The Fed has the power to influence total spending, and ultimately to affect prices, by controlling the supply of money and credit. In doing so, the Fed has pushed interest rates to unprecedented levels. But initially, higher interest rates reduce the level of economic activity, not prices. There are signs that the pinch of tighter money is already being felt by automakers in Detroit and by homebuilders nationwide. Automakers have planned production cutbacks and huge layoffs this month in response to disappointing sales and sizable increases in the cost of financing inventories. And real estate activity is slowing as the availability of funds is reduced and as usury ceilings—even those recently raised—become binding.

This crucial time-lag factor raises doubts about whether the new Fed policy, with its attendant uncertainties, can be sustained in the face of political pressures almost certain to come. If the Fed adopts anything other than a gradual approach to the reduction of the money supply, it risks deepening the recession that now appears to be unavoidable. At the same time, the Fed is encountering a high degree of skepticism from its critics who doubt that its program for reducing inflationary expectations and restoring price stability will work. Nevertheless, supporters of the new tack insist that it must be executed with consistency, arguing that an "on again, off again" approach would only ensure its failure.

E OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				November 7, 1979			
se of IMF edit, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
0	Crude oil price raised 11.8% to $26.27 per barrel.	Dec.	+ 17%	Dec.	+ 39%	—	.2750	A $500-million Euroloan for Sonatrach signed Oct. 24.	**Algeria**
337	Oil export revenues this year projected at $1 billion, net of imports.	June	+ 6%	June	+ 59%	9.00%	1.45	France to lend $138 million for development projects.	**Egypt**
24	IMF grants $23.4-million loan to offset declining coffee export receipts.	May	+ 20%	Apr.	+ 30%	—	.4900	Year-end sees traditional credit expansion.	**Ethiopia**
79	Arrears on foreign loans said to have totaled $400 million at end-July.	Dec. '78	+191%	Apr.	+ 50%	13.50%	.3700	Credit to public enterprises climbs sharply.	**Ghana**
12	Newly-built OAU village to be transformed into tourist haven.	Dec.	+ 9%	Mar.	+ 67%	—	Par	Public-sector credit continues rapid expansion.	**Liberia**
0	Crude oil prices raised.	Dec. '77	+ 60%	June'77	+ 7%	5.00%	3.41	Credit generally available.	**Libya**
15	Need for substantial rice imports continues.	June	+ 12%	Apr.	+ 42%	5.50%	.00495	Credit to public sector expands briskly.	**Madagascar**
224	Import restrictions imposed in September to contain the trade deficit.	Apr.	+ 8%	June	+ 21%	4.50%	.2635	Money supply expanding.	**Morocco**
0	Ban on rice imports protects local producers; trade balance impact modest.	Jan.	+ 16%	Mar.	+ 33%	5.00%	1.78	Credit restraint continues.	**Nigeria**
30	Diamond production continues to decline; price advances slow.	Mar.	+ 13%	June	+ 43%	—	.9990	Credit to Government soars.	**Sierra Leone**
305	Mineral sales set to rise 33% to $11 billion this year.	July	+ 13%	June	+ 9%	7.00%	1.2110	High capital market liquidity continues.	**South Africa**
117	A 45% rise in 1978 imports brings severe import controls.	Mar.	+ 14%	June'78	– 23%	—	.1230	Bilateral aid underpins reserve level.	**Tanzania**
32	Sharply higher oil revenues expected to reduce trade deficit.	Aug.	+ 9%	June	+ 9%	5.75%	2.57	France to lend $44 million for industrial projects.	**Tunisia**
371	Much-improved trade surplus could swing current account into surplus.	Oct. '78	+ 13%	June	+ 9%	—	1.30	Moderate monetary expansion continues.	**Zambia**
0	Substantial crude sales reported at very high spot market prices.	Apr.	+ 11%	Feb.	+ 43%	9.00%	n.a.	Money supply rising steadily.	**Iran**
0	Main crude oil price raised 10% to $21.43 per barrel.	Mar.	+ 8%	June	+ 41%‡	—	3.58	Reduced liquidity keeps interest rates high.	**Kuwait**
0	Jan.-Aug. oil output averaged 9.4 million bpd, up 23% from year earlier.	n.a.	n.a.	May	+ 21%‡	—	.2980	Rial rate cut to 3.35 per dollar from 3.36.	**Saudi Arabia**
0	Abu Dhabi Jan.-Aug. oil output averaged 1.45 million bpd, 1% above year ago.	Dec.	— 2%	Mar.	+ 44%‡	—	.2670	Bank claims on private sector rising more slowly.	**United Arab Emirates**

‡Private sector only

World Interest Rates

market rates of November 7, 1979; bond yields as of November 2, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	14.00	10.00	9.50	6.00	12.00* penalty rate 15.00	8.50	2.00	6.25
Day-to-Day Money	13.50 Nov. 8	14.00	12.00	10.35	11.75	7.00*	12.50*	10.25	0.25	7.625
Treasury Bills 91-day, Middle Rates	12.46	13.50	13.75	14.00 120-day	12.88 one-year	n. a.	11.85* 92-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	12.875 finance paper	14.50 finance paper 15% tax w/h	13.61 H. P. on discount basis	9.90 Certified	12.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.45	14.50 15% tax w/h	14.625	12.00 Certified	not traded	7.40*	14.25*	no market	3.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.43	11.55	13.47	9.50 20% tax w/h	10.47	8.09	13.45*	9.21	3.71	7.93
Industrial Bonds prime, long-term, new and old issues, average yield	10.70 Aa Industrials	11.95	13.15	12.04 20% tax w/h	11.91	8.26	13.84*	9.66	4.92	6.96
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50	15.00	15.00	14.25	10.10	7.25*	17.00*	12.50	4.00	6.50
Bank Time Deposits 3-month	14.00 Cert. of Dep.	14.35 Cert. of Dep.	15.125 Cert. of Dep	14.40	12.9375	9.55*	10.00*	11.00 large deposits	3.875 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	15.4375	no market	14.875	no market	14.25	8.8125	no market	10.3125	3.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8440	2.0935	.0346	.2384	.5597	.001206	.5035	.6154	.0041
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.60 *P*	Flat	1.38 *P*	1.14 *P*	6.71 *P*	1.32 *D*	5.08 *P*	12.15 *P*	7.91 *P*

Eurodollar Deposits

(London, interbank, bid)
November 8

7-day	14.3125
1-month	15.125
3-month	15.75
6-month	15.375

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.10
U.S.-Canada Treasury Bills	−2.03
U.S.-Canada Finance Co. Paper	−3.02
Eurodollars-U.K. Local Auth. Deposits	+1.31

Eurbonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.85
Over 7 yrs.	11.75
DM Bonds	
7 yrs. and under	8.45
Over 7 yrs.	8.55

Gold Price

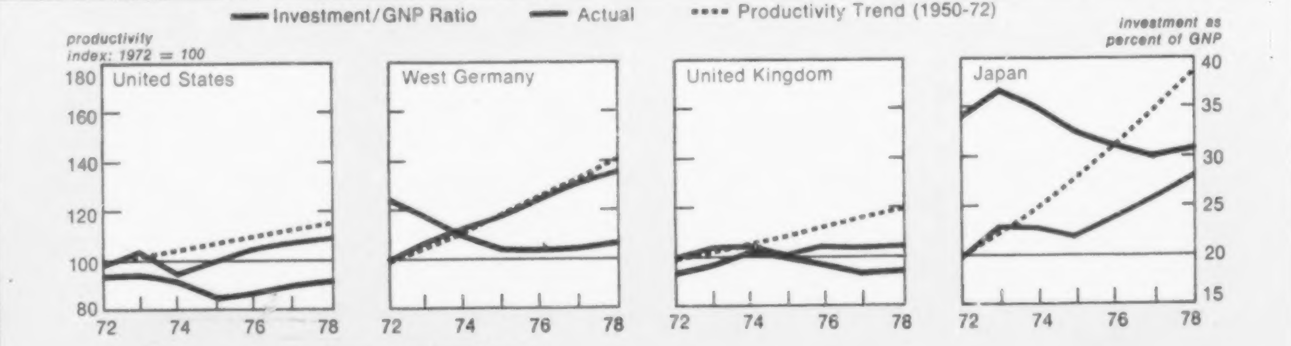
London
afternoon fixing

395.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of October 31; bond yields as of October 26.

Productivity Slowdown: United States Is Not Alone



Data: U.S. Department of Labor, International Monetary Fund

The Worldwide Productivity Slowdown

Lurking behind the statistics of sluggish economic performance in most of the industrial countries is the decline in the rate of growth of labor productivity. The United States and its major trading partners have all seen their productivity growth slacken since 1972, although performance has varied widely from country to country (see charts on bottom of page 6).

In Japan, for example, labor productivity growth fell sharply from an average annual gain of 9.7% during 1950-1972 to a still-robust 4.9% average in 1972-1978, while Germany's rate of productivity increase fell only slightly to 5.3% during 1972-1978, from 5.9% in the earlier period.

The burden of sagging productivity is probably weighing more heavily on the U.S. economy, however, as business conditions soften and rampant inflation persists. The U.S. index of output per hour worked in the private business sector—a standard measure of U.S. labor productivity—fell at an annual rate of slightly more than 2½% in the first half of 1979 before showing a scant 0.1% rise in the third quarter. Although this short-term trend is a legitimate cause of concern, historical experience strongly suggests that the U.S. productivity decline will be reversed as the business cycle bottoms out. More troublesome, however, is the long-term sluggishness upon which the cyclical decline has been superimposed. The trend growth rate in U. S. labor productivity was almost 3% per year in the 1950-1972 period, but only 1½% during 1972-1978.

A major cause of slowing productivity gains in most industrialized countries is increased economic uncertainty, which has acted to inhibit capital formation. But perhaps even more important in recent years is a new phenomenon not yet widely recognized as a cause of slow growth in the capital stock and productivity: the rapid rise in the relative price of energy. While the major determinants of labor productivity are the capital stock and the capital/labor ratio, energy as a factor of production also has a big impact on productivity.

Workers are generally more productive when they have good modern tools in sufficient quantity and an efficiently designed space in which to use them. A nation's capital stock—the mines, the machinery in manufacturing plants, the commercial offices and stores of the service sector—is the set of tools the labor force uses. The stock of capital in the United States grew in relation to the number of employed people at an average annual rate of 2.6% from 1950 to 1972. Since then, this ratio has increased at an annual rate of only 0.3%, and has actually declined in each of the last three years as the relative prices of capital, labor, and energy have changed. Relative prices have shifted in the foreign industrialized countries as well, but not as dramatically—largely because energy prices and taxes were already significantly higher—leading to less favorable capital/output ratios.

Prices serve as an economic signal to guide the allocation of resources. If the price of one good rises relative to other goods, the appropriate buyer response is to utilize less of the more expensive good. During 1950-1972, for example, the relative price of energy fell in the United States. The wholesale price index for fuels and power rose an average of only 1.4% per year, while labor costs rose 4.7% and capital costs about 2½%. Thus, American businesses tended to make investments that minimized the use of labor, with little concern for energy consumption.

From 1972-1978, however, U.S. energy prices almost tripled. Wages, on the other hand, rose only about 50% in the same period, while prices of capital equipment and structures increased 60%. Currently, labor is the productive input whose price is rising most slowly, and U.S. businesses have responded by expanding payrolls extremely rapidly since the last recession. The net stock of capital per worker has failed to keep pace, and labor productivity has suffered. This trend has been reinforced by the fact that capital requires the use of energy, so attempts to cut consumption of energy lead to a reduction in investment as well.

Uncertain economic conditions have been suggested as another cause of lagging capital investment and, hence, slower growth in labor productivity. An investment project may be undertaken with the expectation that, on average, it will yield 10% per year, higher in some years and lower in others. But increasing uncertainty means the range of outcomes will be greater. Since most people and businesses are risk averse, they would require a greater yield, on average, to compensate for the increased riskiness. Thus, fewer investment projects would be perceived as profitable, and investment would fall. Furthermore, those projects still undertaken focus on conserving energy, not labor.

The 1970s have clearly witnessed a worldwide increase in uncertainty, with the shift from fixed to flexible exchange rates, accelerating world inflation, and two large jumps in the price of oil. And as the charts on page 6 show, the growing uncertainty has been accompanied by a decline in the ratio of investment to GNP in the major industrial countries and consequent reductions in labor productivity growth.

It is almost certain that the price of energy will continue to rise relative to both labor and capital, since energy is now viewed as the scarcest resource. Therefore, the major hope for improving labor productivity in the 1980s lies in spurring capital formation to reverse the decline in the investment/GNP ratio and thus increase the capital/labor ratio.

Douglas L. Bendt

Jamaica Pursues Road to Recovery

Since May 1978, Jamaica has been undertaking an economic stabilization program within the context of an IMF Extended Facility Arrangement. By implementing restrictive demand-management policies and introducing corrective price and exchange-rate adjustments, the authorities have sought to reduce the persistent deficits in the government budget and the current account, while attempting to reverse a deteriorating trend in economic activity. And indeed, limited progress toward these objectives was made in the first year the program was in effect, despite adverse internal political repercussions.

Results of stabilization

As a consequence of the austerity effort, the budget deficit of the central government and the state-owned financial entities dropped from an average of 15% of GDP, for the two years ending in fiscal 1977/78 to 11.4% in FY 1978/79. Current revenues rose from an average of 26% of GDP to 30%, as taxes on consumption, production, and trade of a wide range of goods and services were increased, and as the levy on bauxite production—which is denominated in U.S. dollars and is a major source of government revenue—benefited from a depreciating Jamaican currency. Meanwhile, current and capital expenditures were contained to the previous year's level of 28% and 13% of GDP, respectively. In addition, the financial condition of the entities comprising the remainder of the public sector was enhanced through the adoption of badly needed upward adjustments in the prices of the goods and services they provide. This permitted subsidies to be reduced from a peak of nearly 9% of GDP in FY 1976/77 to less than 8% in FY 1978/79.

The improved fiscal situation, combined with greater government reliance on external borrowings to finance the budget deficit, resulted in a halving of the growth rate of domestic credit to the public sector to 36% in FY 1978/79. In turn, this freed funds for use in the private sector and set the framework for gradual reductions in the country's rapid rate of overall monetary growth. Credit to the private sector rose by some 25%, after declining at an annual average rate of 5% in the previous two years. At the same time, increased bank reserve requirements and higher interest rates helped to slow the growth of the monetary aggregates to 14% from a previous annual average of 17%.

To alleviate the balance-of-payments problem, the authorities unified the dual exchange-rate system in effect since 1977 and introduced mini-devaluations of the currency. Secondly, the Government promoted a recovery of tourism; this resulted in the inflow of tourists rising 38% in 1978, in contrast to significant declines for the previous two years. The positive approach to the foreign sector, combined with the restriction of aggregate demand, led to a considerable narrowing in the Jamaican current-account deficit, which shrank from a high of about 10% of GDP in 1975-76 to 5% in 1978.

Impact on growth

The Jamaican Government's fiscal and monetary contraction initially had a negative impact on GDP, which fell by an estimated 2% in 1978. However, this decline in economic activity was small in comparison with the successive 6.7% and 4% declines in GDP during 1976 and 1977. At the present time, the Government's hope for a recovery of national income is more justified because the allocation of resources and incentives for investment have been improved in key sectors, such as agriculture, tourism, and export-oriented manufacturing.

Dealing with inflation

Another inevitable consequence of the Government's adjustment program was an acceleration of inflation from less than 15% in 1977 to approximately 50% in the second half of 1978. This followed mostly from a reduction in subsidies, a relaxation of price controls, increases in sales taxes, and currency devaluation. While inflationary pressures have recently eased, with prices rising at an annual rate of less than 30%, Jamaica's inflation problem is not completely resolved because the budget deficit is projected to be cut only gradually (to a still-high 8% of GDP during the current fiscal year) and there are subsidies yet to be eliminated.

Clearly, inflation is also determined by the degree of monetary restriction and the size of wage increases. In this context, the authorities intend to allow interest rates to play a greater role in augmenting the country's financial resource base and in allocating the available bank credit. To this end, interest rates are to be raised periodically to assure positive real rates of return. Meanwhile, the Government is continuing with an incomes policy that limits wage increases.

In conclusion, Jamaica has taken the first steps to achieve a sustainable expansion of its economy by confronting head-on its fiscal problems and balance-of-payments constraints. If the authorities persevere with their sounder economic policies and thereby regain the confidence of domestic and foreign investors, Jamaica's future growth performance will be substantially enhanced.

Nina Ramondelli

CHASE

International Finance

Vol. XIV, No. 23
November 26, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

Because of the Thanksgiving holiday, this issue of International Finance went to press on November 21.

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NOV 28 1979

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The Risks of Germany's Tight Money Policy

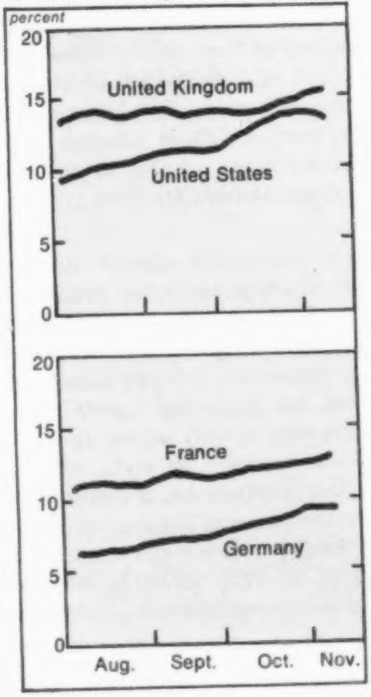
The German authorities continue to hold firm to a tight monetary stance. The recent rises in the Bundesbank's discount and Lombard rates to 6% and 7% consolidate the latest round of DM interest rate hikes. Three-month money market rates have risen throughout 1979, from less than 4% in January to their current 9.5%.

The higher interest rates are the result not only of the Bundesbank's tight monetary stance, but also of the strong growth in domestic demand. Real GNP advanced at an annual rate of over 4% in the first half of the year. The construction industry is now operating at full capacity, and unemployment is at a five-year low of 3.7%, with labor shortages beginning to emerge.

Thus, the Bundesbank has shifted its focus to curbing inflationary expectations. Germany's year-on-year inflation rate has risen from 2.9% in January to 5.7% in October, with much of the increase imported. Indeed, import prices in DM terms rose 17% over this period, while industrial unit labor costs remained flat. The German authorities fear that unless inflationary expectations are brought well below the current inflation rate, wage settlements this winter will internalize the higher rate as labor seeks to recoup much of the added real income transferred to OPEC. The Bundesbank is therefore holding central bank money growth to the lower end of its 6%-9% target range. It is hoped that this will reduce inflationary expectations, both by easing domestic demand pressures and strengthening the DM on foreign-exchange markets, thereby lowering import price inflation in DM terms.

In the face of Germany's restrictive monetary policy, its trading partners have been forced to choose between raising their own interest rates or allowing their currencies to decline vis-à-vis the DM. So far, they have opted largely for the former. But labor markets in these countries function less efficiently than in Germany, and inflationary expectations are more deeply entrenched, particularly in France, Italy, and the United Kingdom. Tighter monetary policy in these countries is thus more likely to affect output than prices, possibly turning a substantial economic slowdown into an outright European recession. Such an outcome would reduce German demand by far more than the Bundesbank is now bargaining for.

Money market rates, internationally
(3-month time deposits)



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U.K. determined to maintain tight money policy, despite the pound's growing strength.

Recent events pose a difficult dilemma for U.K. authorities. On the domestic front, loan demand remains stubbornly buoyant, despite high interest rates and an impending recession. As a result, the domestic money supply has increased at an annual rate of 14%, well above the Government's target range of 7%-11%. On the international front, the realization that sterling is becoming a petrocurrency has encouraged large capital inflows, which have boosted the pound's value to a level far above that justified by international comparisons of cost and price competitiveness. This threatens widespread unemployment in British export industries. At the end of October 1979, sterling's trade-weighted index stood at 66.9 (Smithsonian=100), compared with 63.1 one year earlier and a low of 59.1 in November 1976. Even the abolition of exchange controls in force since World War II led to only a temporary sterling weakness. Still, the Government is determined to stick to its policy of maintaining tight domestic monetary conditions, even if it leads to a further strengthening of the pound. The Bank of England's minimum lending rate has been raised from 14% to 17%, and an extension of the corset scheme for limiting bank lending growth has been announced. Immediately after the policy announcement, sterling jumped from $2.11 to $2.14 and from DM 3.78 to DM 3.82. In the long run, British investors' freedom to invest overseas may lead to large capital outflows. But for the time being, British exporters will have to continue living with an uncompetitive exchange rate.

A neutral 1980 budget proposed by Dutch authorities.

After a 24% annualized rise in the second quarter, third-quarter Dutch industrial production remained unchanged, and order figures point to a relatively sluggish performance for the rest of 1979. With a world slowdown increasingly likely in 1980, the Dutch authorities have proposed a broadly neutral, rather than deflationary, budget for 1980. The deficit of central and local governments is forecast to reach some 16.5 billion guilders, or 5.5% of GNP, compared with an estimated 5.7% this year. Selective job creation schemes, energy conservation incentives, and aid to the housing industry will be financed with a $2.1-billion-guilder increase in Dutch natural gas sales and higher taxes on cigarettes, alcohol, and gasoline. Moreover, income-tax bands will be inflation-adjusted by only 80%. Official forecasts accompanying the government proposals project real GNP growth of 2.5% for 1980, down from 3% this year; a 5.5%-6% inflation rate, up from 4.5% in 1979; and a gas-induced current-account surplus of one billion guilders, after approximate balance in the current account for 1979.

Denmark acts to reduce chronic payments deficit.

The prospect of a further deterioration in Denmark's chronic balance-of-payments deficit has led the new Government to adopt restrictive measures. An immediate freeze has been imposed on prices, dividends, and wages up to January 1, 1980, and the Government hopes to have reached agreement with unions and management by then on a more permanent incomes policy. In an effort to enlist union support, the authorities are proposing higher taxes on wealth and limits on offsetting interest on borrowing against income taxes. More important, the Government is proposing a power-sharing plan under which corporations would have to contribute 10% of their profits to an investment fund administered by the unions. If Denmark fails to reduce its balance-of-payments deficit to more manageable levels, it will be forced to lower the country's high standard of living—GDP per capita was $10,695 in 1978, versus $9,588 for the United States—by deflating its economy and accepting much higher levels of unemployment.

Japanese authorities act to curb capital outflows.

Outflows of long-term capital from Japan in the first nine months of this year totaled $8.5 billion, topping the $7.3-billion level for the comparable period last year. The large capital outflows have clearly had a negative impact on the Japanese economy. They are mainly the outcome of the gap between domestic and foreign interest rates, the mounting rate of inflation, and the weakness of the yen. To reverse the trend, the Government has attempted to encourage capital inflows by liberalizing the money market. Restrictions on foreign borrowings have been relaxed, and the authorities have abolished the limit on purchases by foreign investors of new yen bonds and the ban on non-residents' participation in the "Gensaki" market for Japanese bonds. In addition, discount rates were raised three times in the last six months to narrow the differential between Japanese and foreign interest rates, and Japanese banks were given "guidance" to scale down their overseas lending. While these actions should help reduce the rate of capital outflow in the next few months, the total amount of outflows for 1979 will remain sizeable, at $10 billion or more. This will continue to be one of the influences working to undermine the strength of the yen in the near future.

Inability to check credit growth a major factor in Hong Kong inflation.

Hong Kong's inflation, currently running around 16%-17% on an annual basis, is characterized by a real estate and stock market boom and soaring rents. Factors contributing to the rapid inflation include the large hike in oil prices, the entry of many new firms and banks anxious to participate in trade with China, and a renewed flow of Chinese immigrants, which is putting pressure on housing, transport, and public services. The Government, however, has cited the rapid credit expansion, particularly by foreign banks, as a key influence. With an entirely free exchange market and no central bank, Hong Kong authorities are unable to block credit growth, nor can they directly govern interest rates, which are now two to three percentage points below the inflation rate. The Government has recently threatened a more interventionist approach to monetary policy, but breaking the long-held tradition of free-market policies will not be easy.

Morocco's external deficit curbed by import controls and capital inflows.

Morocco's trade deficit narrowed significantly in 1978 to $1.14 billion. The decline is partly attributable to a 7% rise in merchandise exports, but is mainly the result of a 14% fall-off in imports caused by the imposition of import restrictions and reduced capital spending in the context of an austerity program. The smaller trade gap, coupled with a services deficit of some $960 million and an 18% increase in net transfers to $750 million, helped lower the current-account deficit in 1978 to $1.35 billion from $1.83 billion in 1977. The current-account gap for 1979, however, is unlikely to narrow further, despite the slower pace of economic activity. First-half statistics show the trade gap holding at just about its corresponding 1978 level, with a 12% increase in exports offset by a 7% climb in imports. The higher imports can be traced to the marked rise in the cost of fuel and intermediate goods imports. Although the fuel import bill will continue to climb in the second half, the 1979 current-account gap is not expected to exceed last year's deficit by a wide margin because of the expected further rise in exports, additional import restrictions, a rise in worker remittances, and indications of a larger inflow of official grants.

Cotton share in world fiber market to increase, but prices will weaken.

Despite the late August hail storms in western Texas, the U.S. 1979/80 cotton crop is currently estimated at a near record 14.2 million bales, up more than 30% from the unusually low level of last year. World output is estimated at slightly more than 64 million bales, compared with a 1978/79 level of about 60 million bales. World demand for cotton, which exceeded production last year, will be weakened in 1980 by the recession in the United States and economic slowdowns in other countries. Offsetting this to some extent will be stepped-up export demand from mainland China, the introduction of a permanent-press all cotton shirt this year, and the narrowing price differential between cotton and synthetic fibers stemming from rising costs of petroleum-based feedstocks. Although these factors will probably lead to an increased market share for cotton, it should not be sufficient to prevent a significant rise in cotton inventories accompanied by declining prices.

Bank Borrowing Continues Strong

Growth of overall domestic borrowing from U.S. banks has remained relatively strong, despite the record-high interest rates in the aftermath of the Federal Reserve's early-October tightening moves. Of late, a large part of the borrowing has been by individuals in the form of real estate and personal loans. A resurgence in business borrowing, however, is expected before the end of the year. If such an upturn is coupled with continued rapid expansion of loans to other sectors, funding pressures for banks will increase appreciably.

Total non-business borrowing from commercial banks has been growing at a steady 20% annual rate since early this year, uninterrupted by the October 6 credit-tightening moves. Indeed, in recent weeks loans to individuals for personal expenditures have risen at a 30% annual rate, up from 20% in September. While the outlook is for a moderation of this pace in the weeks ahead, consumer credit demand is nevertheless expected to show seasonal strength during the coming holiday season. Moreover, borrowing from banks by sales finance and personal finance companies increased slightly in October following a drop in September. Much of the finance company relending is ultimately consumer-oriented. In addition, there has been no pause thus far in the strong growth of real estate lending by commercial banks, which has persisted in the 25%-30% range since early spring.

By contrast, business borrowing from banks since mid-October has risen relatively little. However, at New York banks as well as banks outside the city there are expectations of a spurt in business borrowing in the final weeks of 1979. This upturn would reflect slower payments on deliveries, squeezes on profit margins resulting from the business slowdown and from escalating costs, some inventory build-ups, and temporary financing needs linked to corporate tax payments in mid-December.

Overall, total bank loans have risen almost $4 billion, or 11%, in the weeks following the Federal Reserve's tightening actions. Bank funding pressures generated by this expansion have been exacerbated by the bite imposed by the new marginal reserve requirements. Some banks have already exceeded their exempt base for managed liabilities and must now meet the added 8% requirements on net increases of short-term large certificates of deposit, Eurodollar borrowings, certain repurchase agreements, and Federal funds borrowings from non-member institutions. By mid-November, required marginal reserves on these managed liabilities totaled nearly $1 billion. In short, it seems likely that banks will have sizable funding pressures at least through year-end, and possibly longer.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1978		BALANCE O				
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves in millions of dollars	12-month change	months of imports covered	use of credit llions of
Austria	Economic growth continues strong, but is expected to slow in 1980.	May	+ 3.6%	58.1	+ 1.5%	Sept.	4,853	— 7.6%	3.2	
Belgium	Growth to slow in 1980; official forecast of 2.5% likely to prove optimistic.	July	+ 8.4%	96.1	+ 1.6%	Sept.	7,440	+ 30.7%	1.7	
Britain	Recent statistics confirm an economic slowdown.	July	+ 6.0%	308.2	+ 3.2%	Sept.	20,705	+ 17.6%	2.8	1,15
Denmark	New wage and price freeze expected to reinforce deflationary pressures in the economy.	July	+ 4.9%	55.5	+ 1.0%	Sept.	3,446	+ 15.1%	2.5	
Finland	Output remains high, but signs of a future slowdown emerging.	July	+ 9.0%	32.2	+ 2.5%	Sept.	1,979	+ 57.3%	2.5	8
France	Economic activity reviving again following summer stagnation.	June	+ 0.4%	470.5	+ 3.3%	Sept.	19,585	+ 49.8%	2.4	
Germany	Industrial orders beginning to weaken; construction industry overheated.	Aug.	+ 6.5%	639.2	+ 3.1%	Sept.	56,668	+ 26.9%	4.7	
Greece	Fiscal policy turns restrictive as economy overheats; growth expected to decline in 1980.	June	+ 7.7%	31.4	+ 6.2%	Aug.	1,132	— 1.1%	1.8	20
Iceland	Latest indicators point to 2.5% GNP increase this year, versus 4.2% in 1978.	May	+20.5%	2.1	+ 1.4%	Sept.	143	+ 67.3%	2.4	5
Italy	Economic activity picks up after summer slack, but growth set to decline next year.	July	+ 3.4%	237.0	+ 2.6%	Sept.	21,772	+ 54.3%	3.9	
Netherlands	Export-led slowdown seen for 1980; broadly neutral budget proposed.	Aug.	+ 1.9%	130.5	+ 2.5%	Sept.	9,863	+ 23.5%	1,9	
Norway	Rapid economic growth continues, led by expanding oil sector.	Aug.	+ 6.0%	39.7	+ 3.5%	Sept.	4,293	+ 44.5%	4.1	
Portugal	Domestic economy showing signs of increased activity after first-half stagnation.	Apr.	+ 5.3%	18.3	+ 3.2%	Aug.	1,749	— 0.9%	4.0	24
Spain	Domestic demand remains depressed, providing spur for exporters.	June '78	+ 5.4%	141.2	+ 2.9%	Apr.	11,724	+ 54.8%	6.8	2
Sweden	Economic growth slowing, but inflation beginning to accelerate.	Aug.	+ 9.0%	87.2	+ 2.8%	Sept.	3,900	— 12.8%	1.8	
Switzerland	Wage demands beginning to show influence of recent rise in inflation rate.	June	— 1.9%	84.4	+ 0.9%	Sept.	18,841	+ 20.8%	8.2	
Canada	Business slowdown expected as U.S. recession and higher interest and oil costs have impact.	July	+ 3.4%	206.0	+ 3.4%	Sept.	4,511	+ 23.0%	1.0	
United States	Real consumer spending resumes its decline following end-of-summer surge.	Oct.	+ 2.3%	2,098.6	+ 4.0%	Sept.	18,534	0	1.2	

How Deep A Recession?

Recent economic statistics lend credence to the view that the much-heralded recession is truly under way. Housing starts fell 8% in October to a seasonally adjusted annual rate of 1.76 million, and permits for future construction dipped by an even greater 13%. Retail sales dropped nearly 2% after the end-of-summer surge, as auto sales fell from an annual rate of 10.8 million in September to 9.4 million in October. Since consumers and businesses have not had time to adjust their behavior fully to the credit-tightening moves by the Fed on October 6, further fall-offs in activity seem likely. Economists' concerns now focus on the depth and duration of the emerging recession.

As a guide, consider some parallels between the present and the 1973-75 periods. In 1973 and 1978, the U.S. economy attained its maximum potential output: capacity utilization in industry was high and unemployment was near its "full-employment rate."

Some sectors, however, were already declining by the autumn of 1974. Housing starts were about one-third below the year-earlier figure because of the correction of previous private speculative overbuilding, the reduction of huge government subsidies, and deposit outflows at thrift institutions. Auto sales, which reached a record 12.9 million annual rate in March 1973, had fallen below 10 million during the summer of 1974, a response to declining personal income. Personal income—adjusted for inflation and taxes—fell at an annual rate of 7% in the first quarter of 1974 in response to the unanticipated rising oil prices. It fell an additional 1% in the second and third quarters, leading to cutbacks in non-auto consumption as well. Both housing and auto sales fell another 20% in the next several months. The huge reduction in taxes in the spring of 1975 boosted income and ultimately helped turn the economy around.

Thus far in 1979, the declines in activity have not been as severe as in 1974, nor are they likely to be. There are no widespread world shortages of materials that led to overzealous stockpiling by businesses in 1973-74, although automakers must reduce bloated inventories. Homebuilders have also been much more cautious, and overbuilding has been avoided in this expansion. Furthermore, deposit flows at thrifts have been propped up somewhat by money market certificates. Consumption and real disposable personal income were bolstered in the first quarter of 1979 by a tax cut. However, this relief was short-lived, as real income fell at an annual rate of more than 1% in the second and third quarters.

With inflation outstripping previous expectations, the continuing decline in real consumer incomes ensures that a broader retrenching in consumption, production, and employment lies ahead. But the lack of excesses should prevent the economy from plunging as deeply as it did in early 1975.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				November 20, 1979			
MF nil- llars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
	Strong exports reduce current-account deficit below earlier forecasts.	Aug.	+ 3.3%	June	+16.3%	3.75%	.0785	Interest rates continue firm.	Austria
	Heavy foreign borrowing to cover current-account deficit and capital outflow.	Sept.	+ 4.5%	June	+14.6%	10.00%	.03499	Monetary conditions remain restrictive.	Belgium
	Jan.-Oct. cumulative trade deficit at $5.2 billion.	Oct.	+17.2%	Mar.	+ 4.7%	17.00%	2.1730	Domestic credit growth triggers large increase in MLR.	Britain
	Jan.-Sept. trade deficit of kr.14.5 billion, versus kr.11.1 billion in 1978.	Aug.	+12.3%	May	+ 4.2%	11.00%	.1922	EMS obligations force maintenance of high interest rates.	Denmark
	Jan.-Sept. trade deficit of only 101 million markkaa.	Aug.	+ 7.4%	May	+ 9.3%	7.25%	.2653	Markkaa remains strong following revaluation.	Finland
	Trade deficit for 1979 estimated at 10 billion francs.	Sept.	+11.0%	Dec.	+12.4%	9.50%	.2421	Rate hikes abroad lead to higher French interest rates.	France
	Current account remains in deficit; foreign orders decline.	Sept.	+ 5.3%	July	+12.9%	6.00%	.5675	Money policy very tight for upcoming wage round.	Germany
	Current-account gap to top $2 billion in 1979; small narrowing likely in 1980.	Aug.	+20.8%	Apr.	+22.5%	14.00%	.0270	Credit growth limits reduced to 16%; interest rates raised.	Greece
	Higher oil prices likely to produce small balance-of-payments deficit.	Aug.	+41.9%	Aug.	+34.0%	20.50%	.0328	Inability to control money growth fueling high inflation.	Iceland
	Balance of payments posts Lit.589-billion deficit in September.	Oct.	+18.2%	Apr.	+14.7%	12.00%	.001211	Interest rates set to rise further.	Italy
	Higher value of gas exports to offset non-gas export volume decline.	Oct.	+ 4.5%	June	+17.7%	8.50%	.5077	Monetary conditions moderately restrictive.	Netherlands
	Jan.-Aug. current-account gap of kr.4.3 billion, versus 7.6 billion year ago.	Sept.	+ 3.5%	July	+18.4%	7.00%	.2000	Credit conditions continue restrictive.	Norway
	Current account showed surplus of $220 million for first half.	July	+26.9%	June	+19.8%	18.00%	.0210	Large budget deficit makes monetary control difficult.	Portugal
	Continuing rises in reserves imply strong current-account improvement.	July	+15.7%	July	+15.6%	8.00%	.0153	Monetary growth slowing in response to tough credit policy.	Spain
	Payments deficit forces $800-million loan on world capital market.	Aug.	+ 8.2%	Apr.	+21.7%	8.00%	.2382	Interest rates raised to stimulate capital inflow.	Sweden
	Sept. trade gap of SF 445 million, vs. SF 104 million surplus year ago.	Oct.	+ 5.0%	July	+12.6%	2.00%	.6090	Rate tightening anticipated to curb inflationary expectations.	Switzerland
	Capital inflows offset services deficit.	Oct.	+ 9.3%	May	+24.9%	14.00%	.8511	New act would permit foreign bank entry.	Canada
	Current-account surplus anticipated for 1980.	Sept.	+12.1%	Oct.	+15.3%	12.00%	—	Fed's tight credit policy to continue.	United States

World Interest Rates

market rates of November 21, 1979; bond yields as of November 16, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.00	9.50	6.00	12.00 penalty rate 15.00	8.50	2.00	6.25
Day-to-Day Money	12.75	14.00	n. a.	11.00	12.25	7.60	12.50	9.50	1.75*	7.6875*
Treasury Bills 91-day, Middle Rates	12.12	13.60	n. a.	14.25 120-day	n. a.	n. a.	11.97 100-day	no dealing	no market	5.125* 2-month
Commercial Paper prime, 3-month, asked	12.75 finance paper	14.15 finance paper 15% tax w/h	n. a.	9.90 Certified	13.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.60	14.15 15% tax w/h	n. a.	12.00 Certified	not traded	7.40	14.75	no market	3.00* not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.40	11.48	14.25	7.52 20% tax w/h	10.58	8.11	13.54	9.29	3.76*	8.14
Industrial Bonds prime, long-term, new and old issues, average yield	10.60 Aa Industrials	11.75	14.39	12.16 20% tax w/h	12.19	8.31	14.10	9.75	5.07*	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	15.00	n. a.	14.25	13.10	7.25	17.00	12.50	4.00*	6.50*
Bank Time Deposits 3-month	13.625 Cert. of Dep.	14.05 Cert. of Dep.	n. a.	14.35	13.00	9.40	10.00	12.25 large deposits	4.00* residents only	4.00* 20% tax w/h
Eurocurrencies 3-month, asked	15.00	no market	17.625	no market	13.8125	8.75	no market	10.625	3.875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8511	2.1730	.034990	.2421	.5675	.001211	.5077	.6090	.004065
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *P*	1.75 *D*	.875 *P*	.875 *P*	6.125 *P*	2.375 *D*	4.125 *P*	11.125 *P*	7.125 *P*

Eurodollar Deposits

(London, interbank, bid)
November 21

7-day	13.25
1-month	13.8125
3-month	14.875
6-month	14.875

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n. a.
U.S.-Canada Treasury Bills	−1.86
U.S.-Canada Finance Co. Paper	−2.20
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurbonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.875
Over 7 yrs.	11.75
DM Bonds	
7 yrs. and under	8.25
Over 7 yrs.	8.50

Gold Price

London
afternoon fixing

396.15
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of November 14; bond yields as of November 9.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.1 (Sept.)	9.3 (Oct.)	17.2 (Oct.)	11.0 (Sept.)	5.3 (Sept.)	18.2 (Oct.)	5.0 (Oct.)	3.1 (Sept.)
Industrial production*	1.8 (Oct.)	−0.1 (Aug.)	−0.8 (Sept.)	3.0 (Sept.)	3.4 (Sept.)	5.9 (Sept.)	−1.9 (June)	6.9 (Sept.)
Trade balance† *(billions of local currency units)*	−$2.8 (Sept.)	C$.641 (Sept.)	−£.100 (Sept.)	−FF2.9 (Oct.)	DM1.9 (Sept.)	−Lit421 (Sept.)	−SF.445 (Sept.)	−¥103 (Sept.)
Money supply (M_1)*	4.8 (Oct.)	8.5 (Oct.)	12.4 (July)	12.0 (Aug.)	11.1 (Aug.)	19.9 (June)	13.8 (July)	8.9 (Sept.)
Velocity of money (M_1)*	6.6 (June)	5.4 (June)	−4.0 (Mar.)	−5.8 (Dec.)	−3.9 (June)	−5.6 (Dec.)	n.a.	−4.4 (June)
Reserves *(millions of U.S. $, end of period)*	18,534 (Sept.)	4,511 (Sept.)	20,705 (Sept.)	19,585 (Sept.)	56,668 (Sept.)	21,772 (Sept.)	18,841 (Sept.)	25,647 (Sept.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

Books: The "New Order" Revisited

Karl Brunner, editor, The First World & the Third World: Essays on the New International Economic Order. *University of Rochester Policy Center Publications, 1978. 272 pages. $9.95 (cloth), $3.95 (paper).*

Martin M. McLaughlin and the Staff of the Overseas Development Council, The United States and World Development: Agenda 1979. *Praeger, 1979. 268 pages. $18.95 (cloth), $5.95 (ODC edition, paper).*

W. Scott Thompson, editor, The Third World: Premises of U. S. Policy. *Institute for Contemporary Studies, 1978. 332 pages. $5.95 (paper).*

Five years have passed since the United Nations General Assembly first sounded its clarion call for a New International Economic Order that would reshape the world economy in the interests of Third World development. Although not much has been accomplished in these years toward meeting the impassioned demands of the New Order, the U.N. is pushing ahead with plans to launch its third "Development Decade" next year with a special session documenting the NIEO's progress. But even as the preparations proceed, there are signs that the NIEO—grounded more in ideology than realism—is becoming less and less relevant to the pressing issues that bear on the growth and prosperity of the poorest nations.

In light of these circumstances, it seems clear that the development effort is badly in need of a sober reappraisal of the principles and programs that constitute the NIEO. Fortunately, a spate of books has recently appeared that should aid materially in such an assessment. The three volumes listed above are all collections of short articles and essays that deal with various aspects of political and economic relations between the less-developed countries (LDCs) and the industrialized market economies. Taken together, they present a comprehensive portrayal of the problems of the NIEO, along with suggestions for more workable approaches to international development.

For better or worse, little of substance has transpired since the U.N. adopted its NIEO declaration in the spring of 1974, followed by a "Charter of Economic Rights and Duties of States" in December of that year. The economic policy changes contemplated by the New Order included commodity agreements to raise and index prices of primary products, vast resource transfers to the LDCs in the form of foreign aid, assured access to Western technology and markets, and the unquestioned right of every state, as asserted in the 1974 Charter, "to nationalize, expropriate, or transfer ownership of foreign property."

The resolutions were aimed at extracting compensation, or retribution, from the rich countries for alleged past wrongdoings. World trade relationships were to have been restructured in the process, to give favored treatment to Third World exports. But few of the programs have moved beyond the debating halls.

Overtaken by events

A principal reason for the failures of NIEO proposals and doctrines is their increasing irrelevance to current reality. This is persuasively argued by Columbia University Professor Nathaniel Leff in his essay in the Thompson publication. As Leff points out, major international political and economic shifts since 1974 have altered the context, if not the rhetoric, of the North-South dialogue. Chief among these new elements has been the rising price of oil, engineered by a powerful LDC cartel—OPEC—whose actions have severely damaged the development prospects of the non-oil LDCs.

"For most LDCs," writes Leff, "the prospects for attaining high rates of economic growth in the face of the oil-price import constraint are bleak." The oil price hikes, along with other political and economic changes, "have removed the NIEO from the international policy agenda insofar as one is concerned with helping the developing countries."

Leff argues that NIEO rhetoric is serving essentially as a tactic for sustaining LDC support of OPEC's pricing policies. That is, the oil-consuming LDCs have been trapped by NIEO ideology into backing OPEC actions detrimental to their own economic well-being. "With superb diplomatic skill," says Leff, "OPEC has succeeded in maintaining the allegiance of the oil-importing LDCs—despite the impact of higher petroleum prices on Third World economic growth, foreign debt, and external dependency. OPEC has achieved this feat, not by selling the LDCs oil at substantially concessionary prices," he says, but by invoking the mystique of NIEO solidarity.

Leff's incisive observation was dramatically substantiated just last week by news reports from the United Nations. Word filtered out that a plan by oil-consuming countries to press OPEC for stabilized prices and supplies has been scuttled by the Group of 77—the LDC bloc in the U.N. that now numbers 119 countries, including the members of OPEC. According to the reports, the oil-importing LDCs have decided to forgo a push for oil price and supply stability in return for an uncertain possibility of some modest cash transfers from the oil producers. Apparently, in the name of Third World NIEO solidarity, the non-oil LDCs are still willing to act against their own best interests.

Political as well as economic shifts have served to render much of the NIEO agenda obsolete. For ex-

Books: The "New Order" Revisited

(continued from page 7)

ample, according to Leff, as foreign-exchange constraints intensify in the LDCs, many of them have softened their hostility to multinational companies and are welcoming foreign private investment. Moreover, the massive resource transfers contemplated by the New Order have fallen victim, at least in the United States, to changing perceptions by U.S. supporters of foreign aid. NIEO's erstwhile American proponents, writes Leff, have "come to recognize the inherent inconsistency between a large U.S. developmental role and a reduction in LDC dependence." Furthermore, U.S. foreign aid supporters have shifted their focus to such themes as basic needs, human rights, employment growth, and income redistribution—issues for which most LDC governments have shown little enthusiasm. These disagreements have reduced the possibility of a consensus between the LDCs and the U.S. development community over resource transfers.

Fundamental flaws

Beyond the recent setbacks to the New Order, Leff and several other authors in the Thompson and Brunner volumes make a strong case that the fundamental proposals of the NIEO were flawed from the start. For example:

- Commodity prices. As the late Harry G. Johnson points out in the Brunner collection, prices are inadequate proxies for income and wealth. Schemes to raise commodity prices will not all necessarily be as successful as the OPEC effort; in many cases they will cut sharply into demand and reduce income and employment in the producing countries. Furthermore, the higher prices will work both ways, as in the case of oil, since most LDCs import as well as export primary products.

- Resource transfers. Although increases in foreign aid are likely to bring some acceleration of development, "the contribution of these external transfers is at best marginal," argue Peter T. Bauer and Basil S. Yamey of the London School of Economics in the Brunner book. Along with other authors, they point out that many LDCs have limited capacity to absorb foreign capital and that foreign aid can adversely affect mobilization of private capital for development.

- Transfer of technology. Bauer and Yamey are also dubious about the beneficial effects of accelerating the importation of technology by LDCs. "Gratis or subsidized technology transfer is not readily adjusted to complementary factors, market conditions, and institutions," they maintain.

Given the defects of the NIEO proposals, authors in all three volumes generally agree that a more constructive approach to international economic relations will have to emerge if the world development effort is to get off dead center. A World Bank official from Pakistan, Mahbub ul Haq, writing in the Overseas Development Council collection, argues that the international community "should focus its primary attention on exploring areas of common interest" between the two camps. He calls for liberalization of trade barriers rather than establishment of trade preferences for LDCs, a freer flow of labor across national frontiers, and specialization by LDCs "in industries where their comparative advantage is the greatest." He also calls on LDCs to "provide a legally stable framework within which multinationals can operate without undue uncertainty."

In this call, Haq is echoed by many writers in the other books who see a return to market principles as the best hope for world economic development. As Wilson Schmidt of the Virginia Polytechnic Institute argues in his essay in the Thompson book, the international capital market must be allowed to operate freely. If it is, it will provide ample transfers of private capital to LDCs from the rich countries, where the rate of return on capital is lower. "Capital transfers that provide mutual gains," says Schmidt, "are the most viable option to enhance the economic well-being of the poor." It remains to be seen whether the United Nations is ready to accept such a "radical" proposal for its third Development Decade.

Ronald A. Krieger

The Development Gap, by Groups of Countries

	Population, mid-1978 (millions)	Average per-capita GNP, 1976 (US$)	Physical Quality of Life Index (PQLI)*	Birth rate per 1,000	Death rate per 1,000	Rate of natural population increase	Average life expectancy (years)	Infant mortality per 1,000 live births	Average adult literacy rate
Developing Countries (141 countries)	3,163.7	494	56	33	12	2.1%	56	102	49%
Developed Countries (28 countries)	1,052.6	5,036	94	16	9	0.7%	72	18	98%
World (169 countries)	4,216.3	1,628	65	29	11	1.8%	60	81	62%

* PQLI for each country is calculated on the basis of life expectancy, infant mortality, and literacy rates. "Developed" countries are defined as those with per-capita GNP of $2,000 or more and a PQLI rating of at least 90.

Source: Overseas Development Council data, as presented in statistical annex to Martin M. McLaughlin *et al.*, *The United States and World Development: Agenda 1979* (New York: Praeger, 1979).

CHASE

International Finance

Vol. XIV, No. 24
December 10, 1979

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

The next issue of International Finance *will appear on January 7, 1980.*

B 1900-1

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Japan's Yen-Defense Package

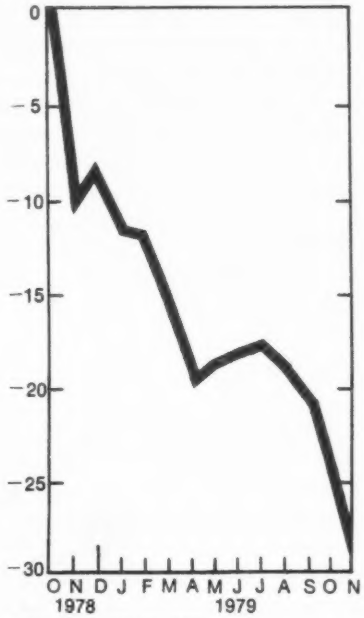
Japan has moved to stabilize the yen, but the market remains uncertain as to whether the actions taken will prove sufficient. The November 27 package was in fact quite modest in scope. The current import settlement program—an import subsidy scheme of limited impact—was suspended. The ceilings on foreign-currency holdings of Japanese banks and foreign banks in Japan were raised. The guidelines on foreign-currency loans to overseas Japanese borrowers were broadened. And a more elaborate and timely set of reporting requirements on foreign-exchange transactions, foreign-currency holdings, and purchases of securities denominated in foreign currencies was established. More interesting than what *was* done was what *was not*. The discount rate was held at the 6.25% level set on November 2. And a system of administrative controls designed to reverse the build-up of "leads and lags"—early payment for imports and delayed conversion of export earnings—was not put in place.

What these moves indicate most clearly is the uncertainty of the authorities as to how best to cope with the inherent conflicts between the three main objectives of Japanese monetary policy: the avoidance of wide swings in domestic interest rates, exchange-rate stability, and the gradual internationalization of the yen. The key element of policy continues to be a commitment to a style of monetary management that stresses allocation of credit by administrative decision—"window guidance"—rather than by price. Thus, although credit conditions in Japan are currently very tight, the differential between yen and dollar interest rates remains considerably larger than the difference between expected inflation rates. In the past, administrative controls would have constrained the inevitable tendency to capital outflow in such a market environment. But the freeing of capital movements associated with the move toward internationalization of the yen has relaxed this constraint.

Yen weakness was inevitable given the extreme uncertainty over the availability and price of oil and the deterioration of the Japanese current account, but the increased volatility of short-term capital movements has greatly magnified this downward pressure. Should a further attack on the yen occur, the authorities may well reverse course and implement a system of administrative controls designed to bring capital outflows under stricter control. But it is by no means certain that these controls would be highly effective.

Yen depreciation against the dollar

percent



Base = October 31, 1978

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Belgian authorities opt for budget austerity and foreign borrowing.

The Belgian economy remains in high gear. GDP growth is expected to reach 3.5% this year, compared with 2.5% in 1978. The balance-of-payments deficit has begun to widen, however, and inflationary pressures have intensified. Another cause for concern has been the series of speculative raids on the Belgian franc over the course of this year. The Government has responded to these developments by requesting major commercial banks to arrange for a $1-billion loan on the international capital market, with additional foreign borrowings anticipated. The authorities have also unveiled an exceptionally austere budget for 1980. Expenditures are to be cut and tax receipts increased, with the added revenues to come from higher taxes on gasoline and new taxes on highway usage. The Government's budget deficit is scheduled to remain constant in nominal terms, thus reducing its share of GDP from 7% in 1979 to 6.5% in 1980.

High inflation and external-account deterioration plague Swedish economy.

Sweden's declining economic performance is in large part the result of higher oil prices and the impending world recession. The major results are rising inflation and balance-of-payments deterioration. Domestic inflation has accelerated, reaching an annualized 8.4% in October, versus 5.9% at the start of the year, and the producer price index—up 12% over the last twelve months—promises still further increases. The high inflation has already triggered compensatory wage demands that have been met as part of the current national wage settlement. As for the current-account balance, a deficit of kr. 10 billion has been officially estimated for the January-August period. And a considerably worse figure is expected for the year as a whole, in contrast with a deficit of only kr. 4.6 billion in 1978. In response, the authorities have announced plans to borrow $800 million abroad. They have also tightened domestic credit, raising the official discount rate three times in the last five months to its current record level of 9%.

New Zealand's current-account deficit to widen.

New Zealand's current-account deficit is expected to widen in the current fiscal year ending March 31, 1980. Overall export growth will slow to less than 10%, versus 22% in fiscal 1978/79, as a result of weaker demand for wool and dairy products—which account for almost one-third of total exports. Earnings from meat exports, about one-quarter of total export receipts, rose 33% in the first five months of this fiscal year, but growth is slowing in the second half because of decreased domestic availability of cattle for slaughter. Manufactured exports, up some 30% in the first five months of the fiscal year, are expected to continue firm as a result of the June 1979 devaluation of the New Zealand dollar. On the import side, rising oil and commodity prices will boost import expenditures about 10% in FY 1979/80, up from 7.5% growth last year. Although the trade surplus will expand to $650 million from $606 million in FY 1978/79, higher debt-service payments and freight costs will widen the current-account deficit to $555 million from $477 million last fiscal year.

Korea courts orderly transition of political power.

The death of President Park on October 26 promised a period of potential uncertainty for Korea. Just one month after the assassination, however, the Government of acting President Choi Kyu-Hah appears to be functioning smoothly. Stabilization policies implemented at the end of 1978 are being maintained, and no abrupt policy shifts or major initiatives, such as devaluation, are likely to be undertaken by the interim government. Meanwhile, the high inflation rate persists, and the balance of payments on current account is deteriorating—a deficit of at least $3.5 billion is expected for 1979. Although inflation should moderate in 1980, higher oil prices and a U.S. recession threaten an even larger current-account gap. As a result, Korea's need for loans from abroad will continue strong. An awareness of the need to preserve international creditworthiness, along with the fear of North Korea, are strong incentives favoring a peaceful transition of political leadership.

The Chase Introductory Seminar on International Financial Management

February 4-8, 1980	*Fontainebleau*	*Miami, Florida*
March 17-21, 1980	*Kahala Hilton*	*Honolulu, Hawaii*

How do the international capital and money markets function? What are the risks in international financial transactions—and what protective measures are available? How can one best cope with complex currency regulations?

Experienced international financial managers may know the answers to these questions. But what about the finance manager who has just been given international responsibility or the executive who is considering international expansion?

Chase Manhattan's Multinational Financial Services Division has designed a four and one-half day seminar especially for those executives with little or no experience in international financial management, who must develop insights and skills as rapidly as possible. It's a *work*-seminar conducted by Chase experts who have profit responsibility for their respective areas—people who know the ropes and can point the way.

This seminar has been presented for the last two years in various locations and has attracted attendees from corporations, financial institutions and governments around the world. The mix of theory and practice has had global appeal since the problems associated with international operations and transactions are universal. Throughout the seminar, attendees are encouraged first to absorb the theoretical outlines of the subjects discussed and then to see them applied in practice. Actual problem solving sessions are incorporated into the program to simulate the kind of situations that participants will confront in their internationally oriented positions.

Examine the outline below and join the hundreds of previous attendees that have found the seminar to be an enormously useful experience. A registration form is provided.

Day I—Monday

(1)	Introduction and Overview	9:00 a.m.- 9:30 a.m.
(2)	Understanding International Economics—Our present monetary system	9:30 a.m.-10:45 a.m.
	10:45 a.m.-11:00 a.m. Coffee Break	
(3)	Forecasting foreign exchange rates—the economic variables	11:00 a.m.-12:30 p.m.
	12:30 p.m.-2:00 p.m. Luncheon	
(4)	The foreign exchange markets—terminology, institutions, practices	2:00 p.m.- 5:00 p.m.
	3:30 p.m. Coffee Break	

Day II—Tuesday

(5)	International Accounting	9:00 a.m.-10:30 a.m.
	10:30 a.m.-10:45 a.m. Coffee Break	
(6)	The fundamental theories of international finance and their ramifications	10:45 a.m.-12:15 p.m.
	12:15 p.m.-1:45 p.m. Luncheon	
(7)	International financial risks— defining and analyzing foreign exchange exposure	1:45 p.m.- 3:15 p.m.
	3:15 p.m.-3:30 p.m. Coffee Break	
(8)	Protection from financial risks—traditional hedging and covering techniques	3:30 p.m.- 5:00 p.m.

Day III—Wednesday

(9)	Problem solving workshop— foreign exchange transactions and related problems	9:15 a.m.-12:15 p.m.
	10:30 a.m.-10:45 a.m. Coffee Break	
	12:15 p.m.- 1:45 p.m. Luncheon	
(10)	Exchange controls—what, how, why?	1:45 p.m.- 3:15 p.m.
	3:15 p.m.-3:30 p.m. Coffee Break	
(11)	International Cash Management	3:30 p.m.- 5:00 p.m.
	Evening—Chase Sponsored-Cocktail Reception	6:00 p.m.- 7:00 p.m.
	Dinner	7:00 p.m.

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Day IV—Thursday

(12)	Special Techniques in International Finance, Swaps, intercorporate clearings, parallel loans, back to backs	9:00 a.m.-10:00 a.m.
(13)	Analyzing International Financial Transactions	10:00 a.m.-11:00 a.m.
	11:00 a.m. Coffee Break	
(14)	Evaluating overseas subsidiary performance	11:15 a.m.-12:30 p.m.
	12:30 p.m.-2:00 p.m. Lunch	
(15)	International Capital markets, national sources of funds	2:00 p.m.- 3:30 p.m.
	3:30 p.m. Coffee Break	
(16)	Techniques in international trade financing	3:45 p.m.- 5:00 p.m.

Day V—Friday

(17)	International Taxation	9:00 a.m.-10:30 a.m.
	10:30 a.m.-10:45 a.m. Coffee Break	
(18)	The cost of capital for the MNC	10:45 a.m.-11:30 a.m.
	Borrowing foreign currencies	11:30 a.m.-12:00 p.m.
	Seminar ends at	12:00 noon

Introducing the discussion leaders

Gerald Kramer – *Vice President,* Multinational Financial Services Division.

Mr. Kramer's primary responsibility is advising Chase's corporate and institutional clients on international financial problems. He holds a B.A. in economics and an M.B.A. in international finance and economics. He has been an international tax analyst at Texaco, an international economist at Chase and a financial editor and consultant at Business International Corp. Mr. Kramer is an adjunct professor of International Business at the University of South Carolina, adjunct professor of finance at Beaver College, a frequent lecturer on economic and international business matters, and an author of many articles for business publications.

Frederick C. Militello, Jr. – *Vice President,* International Treasury Management Consulting.

Mr. Militello holds a B.A. and M.A. in economics and an M.I.A. degree in international economics from Columbia University. In 1969, he was given the *Wall Street Journal* award in economics and was admitted to the National Social Science Honor Society. He is currently Adjunct Professor of Economics at Pace University. In 1973, he joined Business International Corporation, where he became Assistant Director – Financial Services and Senior Editor of the BI Money Report.

Advance Registration Form

Please register me for THE CHASE INTRODUCTORY SEMINAR ON INTERNATIONAL FINANCIAL MANAGEMENT:

☐ February 4-8, 1980 at the Fontainebleau, Miami, Florida.
☐ March 17-21, 1980 at the Kahala Hilton, Honolulu, Hawaii.

Name______________________________

Title______________________________

Company____________________Phone (   )__________

Street______________________________

City____________State____________ZIP__________

☐ *Enclosed is my registration fee of $975.** ☐ *Bill me* ☐ *Bill my company*

** Fee does not include travel arrangements or hotel accommodations. Please make check payable to The Chase Manhattan Bank, N.A. Additional participants from the same company at the same seminar pay a 50% reduced fee.*

Mail this Seminar Registration Form (with your check if you wish) to:

Ms. Linda A. Ladolcetta
Assistant Treasurer
The Chase Manhattan Bank, N.A.
Multinational Financial Services Div.
1 Chase Manhattan Plaza, 20th Floor
New York, New York 10081

C

Strong exports a key contributor to Malaysian growth.

The Malaysian economy has continued to expand at a vigorous 8% pace this year. GNP per capita in 1979 is estimated at $1,440, comparable with that of Korea and Taiwan. A strong export performance has been a major influence. Buoyant commodity prices have boosted export growth to 22.4%, bringing total exports to approximately $9.7 billion so far this year. The petroleum sector is leading the export surge with an increase in net earnings of more than 80% to $1.3 billion. The trade balance, which has been in surplus since 1976, will post a surplus of slightly more than $1.0 billion this year, and foreign-exchange reserves are expected to approach $4 billion by year-end. The slowdown in OECD economic growth in 1980 will weaken commodity export receipts, but the Government is unconcerned about curbing imports in view of the favorable long-term growth potential and the country's high creditworthiness on the international capital market.

Portugese prospects brightened by external-account buoyancy.

Despite some disturbing indicators, Portugal's economic prospects appear more promising. Although inflation is now running at slightly less than 24%, with the budget deficit likely to top 121 billion escudos, restrictive credit policies and a depreciating currency have been a boon to the trade balance. Export revenues increased 43% during the first half of 1979, while imports rose only 15%. The current account posted a deficit of $276 million for the first half of 1979; but the gap was more than offset by capital inflows, to yield an overall payments surplus of $220 million. Even with higher oil prices in the second half, Portugal's current-account deficit for 1979 is unlikely to exceed $500 million, compared with a shortfall of $800 million in 1978. In a vote of confidence, the Central Bank has cut its minimum lending rate from 18% to 17% and has reduced its target for the controlled mini-devaluation of the escudo from 0.75% to 0.5% per month.

Hurricane damage to Dominican Republic less than previously feared.

The hurricane that struck the Dominican Republic in September caused a significant amount of damage, but revised estimates of losses are well below those initially feared. Total costs of foregone production and to inventories and productive capacity are estimated at $840 million. Much of the damage of a more permanent nature, however, has been repaired already as part of a three-month emergency program. The agricultural sector suffered the greatest losses, but damage was concentrated in domestically consumed short-cycle crops, production of which has resumed. Export crops were not affected greatly, and, in fact, the sugar crop—the country's major source of foreign-exchange earnings—had been harvested and exported prior to the hurricane. Real GDP growth in 1979, which was estimated at 6% before the hurricane, is now projected at 4.8%. Still, this is significantly better than the 2% growth posted in 1978. And because of insurance payments and international aid, the current-account deficit is expected to shrink from $375 million in 1978 to less than $300 million this year.

Shortfall in world tea crop will fuel price rises.

A continuing drought in India, the world's largest tea producer, is likely to reduce world production this year by 1½%-2% from the record level of 1.48 million metric tons in 1978. World tea consumption, which declined last year largely as a result of a steep drop in U.K. consumption, appears to have strengthened again this year in response to sharply higher coffee prices. While coffee prices are now running 45% above year-ago levels, tea prices are still below their level last year because of a large supply overhang and India's decision to abolish export ceilings and duties. The New York import price of medium-quality tea from Sri Lanka and India has declined steadily from its 1977 high of $2.11 per pound (coinciding with the freeze-induced coffee shortage) to this year's low of 96.4¢ per pound in June, before rising again to $1.06 per pound in October. Some further price gains are anticipated in coming months as currently ample inventories are reduced.

Has Monetary Policy Eased?

While short-term interest rates have fallen significantly from their early November levels, it is improbable that this decline represents an easing of monetary policy. Indeed, a Fed official suggested last week that some market participants had misinterpreted the forces behind the decline. He implied that the decline was consistent with the Fed's new strategy of placing greater emphasis on bank reserves, and less on the Federal funds rate, in controlling money growth. The slowing of growth in both the monetary aggregates and bank reserves since late October has been the major factor behind the weakness of interest rates. By the same token, however, a re-acceleration in money or reserve growth could quickly cause short-term interest rates to rise again. In sum, continued large fluctuations in rates are quite possible in the months ahead.

The recently released minutes of the October Federal Open Market Committee (FOMC) meeting suggest that the recent volatility in interest rates—and the uncertainty it created—were not by themselves viewed as undesirable. This is suggested not only by the exceptionally wide 11½%-15½% trading range for the Federal funds rate set at the meeting, but also by the statement in the minutes that the increased "uncertainty about the near-term course of interest rates . . . should induce banks to exercise greater caution in extending credit and might dampen speculative behavior by increasing its risks and costs."

It was also noted in the minutes that bank reserves in the latter part of October had been growing too rapidly in the FOMC's view to be consistent with fourth-quarter money growth targets. Thus, even with Federal funds trading around 15½%, "continued pressure on money market conditions" appeared appropriate. Since then, however, a significant slowdown in the growth of reserves and the monetary aggregates has coincided with substantial declines in the funds rate.

Obviously, money market rates will remain highly sensitive to movements in the growth of money, reserves, and short-term credit. Nevertheless, it is worth noting that at least part of the recent slowdown in seasonally adjusted M_1 growth appears to be the result of questionable seasonal adjustment factors. These have probably caused the "true" adjusted money growth rate to be understated. Indeed, even before the October 6 policy actions, most money forecasters had projected a slowdown in M_1 growth in the October-November period based on their perception that these seasonal factors were flawed. This seasonal weakness in seasonally adjusted M_1 growth is not expected to continue into December. Moreover, a resurgence in business borrowing—especially around the December tax- and dividend-payment dates—is a distinct possibility. Thus, it seems premature to conclude from the recent behavior of interest rates that they will decline from now well into 1980 without further interruption.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANC				
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves in millions of dollars	12-month change	months of imports covered	li
Asia	Bangladesh	Severe drought last year left food gap of 3 million tons; December harvest relief awaited.	Apr.	+11%	7.8	$ 93	Sept.	461	+ 49%	4.0	
	Burma	Private-sector role constrained by Government's socialist orientation, but free markets thrive.	Aug.	+92%	4.3	135	Sept.	201	+ 48%	5.5	
	China, People's Republic	Moderate growth and good harvest in 1979 raise prospects for steady growth in 1980.	June	+40%	445.0	450	June	3,528	+ 12%	3.3	
	Hong Kong	Economic boom led by real estate and stock market shows little sign of abatement.	July	+36%	13.3	2,904	n.a.	—	—	—	
	India	Low agricultural production, increased political uncertainty, and industrial disputes dampen growth.	June	+ 3%	140.4	219	May	7,506	+ 23%	12.7	
	Indonesia	Rice production will fall short of target this year; poor weather a factor.	May	+18%	47.4	326	Sept.	3,341	+ 40%	4.9	
	Japan	Higher corporate taxes anticipated in move to reduce dependence on deficit financing.	Aug.	+11%	980.2	8,531	Sept.	25,647	— 14%	4.4	
	Korea	Interim government promises to continue Park regime's stabilization policy.	July	+23%	47.4	1,279	July	5,083	+ 18%	4.2	
	Malaysia	Budget for 1980 includes largest tax cuts ever for individuals and corporations.	June	+48%	14.9	1,153	July	3,788	+ 30%	7.6	
	Pakistan	Government plans to de-nationalize many state-owned enterprises.	July	+21%	18.2	237	Sept.	241	— 67%	0.9	
	Philippines	Government launches effort to source foreign funding for $6-billion industrial expansion.	July	+37%	23.3	503	Sept.	2,143	+ 14%	5.4	
	Singapore	Shift to higher-technology industries gathers momentum with recent wage hike.	July	+39%	7.7	3,285	June	5,500	+ 24%	5.5	
	Sri Lanka	Elimination of food and other subsidies helps reduce budget deficit this year.	May	+ 3%	2.5	173	Sept.	461	+ 34%	6.2	
	Taiwan	One year after U.S. de-recognition, economy growing at 8%, with strong foreign investment.	Aug.	+23%	24.0	1,124	Sept.	1,556	0	1.8	
	Thailand	Sugar production shortfall prevents fulfillment of ISA export target.	July	+24%	21.7	482	Sept.	2,225	— 2%	5.3	
Oceania	Australia	Drought lowers wheat production for 1979/80 season to 14.5 million metric tons.	Sept.	+34%	107.9	7,569	Sept.	4,331	+ 16%	3.7	
	Fiji	Revival of building and construction provides impetus for growth in 1979.	June	+15%	0.6	1,142	Sept.	118	— 14%	4.7	
	New Zealand	Recent increases in government spending continue to favor consumption over investment.	Aug.	+19%	13.8	4,409	Sept.	631	0	2.5	

Savings Ebb as Inflation Persists

Personal saving as a percentage of disposable income was an anemic 4.3% in the third quarter of 1979, and a new monthly series indicates that the rate actually fell below 4% in both September and October. The savings rate has been above 5½% in 85 of the 119 quarters since 1950. Since the third quarter of 1976, however, the rate has consistently been below 5½%.

When faced with increased uncertainty, as in time of war, Americans tend to increase their rate of saving. Unanticipated or accelerating inflation also heightens uncertainty; fears grow that monetary and fiscal restraint will be imposed, leading to cutbacks in production and employment. Individuals respond to the perceived danger of unemployment by saving more to buttress their future standards of living. These fears were justified during the 1950-65 period by the actions of the U.S. Government and the Federal Reserve, whose restrictive policies ensured that outbursts of inflation would not intensify or become prolonged.

Since 1965, however, policymakers' reactions to inflation appear to have changed and, consequently, so have those of savers. Monetary policy, which had been tightened in 1966 in response to accelerating inflation, was eased in 1967 to accommodate the higher Federal spending stemming from the Vietnam War. As a result, a full-scale recession was averted, and unemployment was held down by sharp increases in the armed forces. Inflation soon re-accelerated, but this time there was a difference: people saved less, not more, in 1968-69. With their jobs seemingly secure, they were coping with expected inflation by engaging in "anticipatory buying."

The saving rate did increase sharply in 1970, reflecting a 2½-percentage-point rise in the unemployment rate. But this policy-induced recession failed to eliminate the inflationary expectations formed in the previous four years, since restrictive fiscal and monetary policies were reversed before actual inflation showed any signs of abating. The inflation rate, which accelerated in 1973-74 to 12%, fell by half in the wake of the severe recession. But policy again turned expansionary before inflationary expectations could be reduced to their pre-1973 level. Two subsequent tax cuts, an expanded public-works program, and faster monetary growth have combined to bring about accelerating inflation once again.

Individuals have been borrowing heavily to keep their spending ahead of the expected continuing inflation. But because credit conditions have recently tightened, making a rise in unemployment more probable, the saving rate is likely to turn up from the depths of the late summer and early autumn. Such a forced shift in behavior does not necessarily mean that basic attitudes toward saving have changed. Consumers must be convinced of policymakers' new resolve to fight inflation, despite rising unemployment, before they permanently alter their expectations and increase their level of savings.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
se of IMF redit, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
						December 5, 1979			
220	Growing remittances and foreign aid continue to boost reserves.	Sept.	+17%	July	+ 21%	—	.0650	Credit squeeze maintained to fight inflation.	Bangladesh
82	High prices for rice and teak and resumed oil exports are promising.	Aug.	+ 6%	n.a.	—	—	.1550	Monetary policy relaxed to stimulate investment.	Burma
—	Import growth eased in second-half 1979.	n.a.	—	—	—	—	.6800	Soft loans sought from Japan for power and transport projects.	China, People's Republic
—	Exports rising strongly, but imports driven still higher by domestic boom.	July	+12%	Sept.	+ 45%	—	.2015	Credit growth rapid; Government threatens restraint.	Hong Kong
0	Trade gap may reach $2 billion in FY 1980, owing to rising oil imports.	Aug.	+ 9%	July	+ 22%	9.00%	.1245	Credit restrictions unlikely to ease in near future.	India
0	High prices for oil and other commodities promises payments surplus.	Aug.	+26%	May	+ 40%	—	.001650	Money supply continues rapid growth.	Indonesia
0	Large capital outflows undermine yen strength.	Aug.	+ 3%	Aug.	+ 11%	5.25%	.004070	Relatively tight monetary policy continues.	Japan
138	Current-account deficit may exceed $3.5 billion in 1979, as exports lag.	Aug.	+18%	Aug.	+ 36%	15.00%	.0022	Credit remains tight.	Korea
0	Rubber and tin export duties cut; palm oil duties raised.	Aug.	+ 3%	July	+ 8%	—	.4602	Government continues policy of credit expansion.	Malaysia
434	Trade deficit nears $2 billion as imports soar.	Aug.	+12%	June	+ 24%	10.00%	.1020	Credit expanded to small-scale agricultural producers.	Pakistan
628	Payments deficit widens; Government negotiates for new IMF, IBRD credits.	Aug.	+23%	July	+ 27%	4.00%	.1365	Monetary restraint continues.	Philippines
0	Trade deficit may reach $4 billion this year as imports soar.	Aug.	+ 5%	June	+ 14%	—	.4608	Credit conditions remain restrictive.	Singapore
271	First-half trade deficit of $266 million, versus $20 million year earlier.	Aug.	+ 6%	May	+ 35%	10.00%	.0675	Restrictive monetary policy continues.	Sri Lanka
0	Exports to top $15 billion in 1979; current-account surplus likely.	Sept.	+14%	Aug.	+ 21%	14.00%	.0290	Money supply growth at 15%, lowest in years.	Taiwan
239	Trade deficit may reach $1.9 billion in 1979, with oil imports high.	Aug.	+ 7%	June	+ 35%	12.50%	.0510	Credit conditions remain tight to curb inflation.	Thailand
325	Preferential tariff treatment for U.K. suppliers of 500 products dropped.	June	+ 9%	July	+ 13%	—	1.0975	Pressure on short-term rates weakens as U.S. rates fall.	Australia
9	Increased earnings from tourism help offset widening trade deficit.	Aug.	+ 7%	Aug.	+ 34%	—	1.1850	Easy credit maintained to spur investment.	Fiji
392	Recent freight-charge increases worsen invisibles-account deficit.	June	+12%	June	+ 20%	13.00%	.9775	Restrictive credit conditions continue.	New Zealand

World Interest Rates

market rates of December 5, 1979; bond yields as of November 30, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.00	9.50	6.00	15.00 penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	13.125 Dec. 6	14.75	17.00	9.50	12.00	8.80	12.50*	18.50	3.25	8.1875
Treasury Bills 91-day, Middle Rates	11.65	13.55	16.00	14.30 120-day	n. a.	n. a.	12.47* 91-day	no dealing	no market	5.125 2-month
Commercial Paper prime, 3-month, asked	11.75 finance paper	13.80 finance paper 15% tax w/h	14.80	9.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.65	13.80 15% tax w/h	16.5625	12.00 Certified	not traded	8.40	14.65*	no market	3.25 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.45	11.25	14.32	10.02 20% tax w/h	11.09	7.85	13.54*	9.08	4.04	8.22
Industrial Bonds prime, long-term, new and old issues, average yield	10.30 Aa Industrials	11.50	14.89	12.42 20% tax w/h	12.33	8.09	14.12*	9.75	5.15	6.94
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	14.75	13.10	10.25	17.00*	14.50	4.00	6.50
Bank Time Deposits 3-month	12.625 Cert. of Dep.	13.75 Cert. of Dep.	16.8125	14.50	12.625	9.45	10.00*	15.50 large deposits	5.625 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.1875	no market	16.875	no market	13.75	9.0625	no market	14.25	5.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8572	2.1860	.035310	.2444	.5740	.001228	.5181	.6242	.004071
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.50 *P*	2.50 *D*	.25 *D*	FLAT	5.00 *P*	3.625 *D*	FLAT	8.125 *P*	5.25 *P*

Eurodollar Deposits

(London, interbank, bid)
December 6

7-day	13.375
1-month	14.125
3-month	14.0625
6-month	13.75

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.63
U.S.-Canada Treasury Bills	−1.78
U.S.-Canada Finance Co. Paper	−2.36
Eurodollars-U.K. Local Auth. Deposits	+ .06

Eurbonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.55
Over 7 yrs.	11.65
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	7.875

Gold Price

London
afternoon fixing

426.40
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market Rates as of Nov. 28; bond yields as of Nov. 23.

Irish Economic Indicators

	1977	1978	1979 (est.)	1980 (est.)
Gross Domestic Product*	5.5	5.9	2.7	3.0
Investment as percent of GDP	25.1	26.9	30.0	28.0
Consumer prices*	13.6	7.6	13.0	11.5
Money supply (M_3)*	24.0	24.2	16.0	16.0
Public-sector deficit (£ million)	572.1	866.1	883.1	800.0
Current-account balance (£ million)	−149	−165	−625	−400

* percent change from year earlier

Irish Currency Switches Allegiance

Ireland's economy continues to outperform its European Economic Community (EEC) partners, with real GDP growth of 5.5% in 1977 and nearly 7% in 1978. (See table on bottom page 6.) The twin engines of growth have been exports—primarily agricultural—and investment. These have been encouraged by the Government's continuing commitment to rapid growth and generous tax incentives.

On the external front, strong domestic demand during the last two years has greatly increased imports and widened the trade deficit. The larger trade gap has been partly masked in the far smaller current-account deficit because of aid and grants received from other EEC members.

It is becoming increasingly clear, however, that Ireland's growth rate will decelerate over the next few years. Real GDP is expected to increase only 2.7% this year and an estimated 3.0% in 1980. While this represents a definite slowdown, growth will remain high by historical standards and relative to projected European growth rates. The anticipated economic buoyancy is based on expectations of continued growth increases in the agricultural and export sectors.

The currency issue

An important influence on the future course of economic growth stems from the separation of the Irish currency—the "punt"—from the pound sterling against which it had been pegged on a one-to-one basis. The split from sterling was hailed for providing Ireland the opportunity to pursue an independent monetary policy. What it did in fact do was to force Ireland to accept the monetary consequences of its balance-of-payments position and its domestic budgetary stance.

Under the old system, financial markets viewed the United Kingdom and Ireland as a unified currency area. Even when Ireland's balance-of-payments and budget deficits were large by domestic standards, they appeared small relative to the U.K. monetary system and could be financed without any significant effect on the area's interest-rate structure or exchange rate. Thus, while the separation of the punt has introduced the exchange rate as another policy instrument, it has also altered the policy implications of the old instruments, thereby limiting the Government's freedom of action. Specifically, the balance-of-payments and budget deficits are now viewed in the context of the relatively small Irish economy and will have to be kept within narrow limits if Irish interest rates and the punt exchange rate are to be controlled.

In addition, by joining the European Monetary System (EMS), Ireland has taken on the added pressures of harmonizing its economic performance and policies with those of its stronger and wealthier EMS partners. Indeed, the most important set of problems now facing the authorities stem from the punt's separation from sterling and the imperatives of EMS membership:

- *Wage control.* If the newly independent punt is to participate in the EMS on an equal footing with the other member currencies, wage increases will have to moderate. Wage negotiations have been difficult over the last year, and several long and damaging stoppages have occurred. Settlements have come in at very high levels, with earnings in manufacturing up nearly 15% in 1978 and expected to rise similarly this year. The Government has sought to enlist labor's cooperation by emphasizing that Irish wage increases cannot exceed those granted on the European mainland—assuming comparable labor productivity gains—if the punt is to remain in the EMS with only small adjustments in parity. However, the dominant influence of the U.K. labor market on settlements in Ireland lingers, and there are few signs of any long-term shifts in attitude. This points to the likelihood of several falls in the punt's value within the EMS over the next few years.
- *Balance of payments.* Because of the limited market for the punt in foreign-exchange markets, it is unlikely to come under any heavy speculative pressure. Rather, devaluation pressures will derive from a loss of export competitiveness, which produces, or threatens, a weakened balance of payments and rising unemployment. Thus, the authorities will need to maximize the competitiveness of export industries (partly by curbing wage increases) and check the growth of imports. Nevertheless, with its dependence on imported energy and its relatively rapid pace of growth, Ireland looks set to run a current-account deficit for some years to come. The challenge is to minimize the deficit and sustain the current high level of capital inflows.
- *Monetary policy.* Monetary policy has not yet fully accommodated itself to the fact that with an independent punt the public sector's borrowing is now a major influence on the narrow domestic money market. Large increases in the public-sector deficit have resulted in sharp rises in the nation's money supply growth and significantly higher interest rates.

The monetary authorities have, however, recognized the need for restraint. They introduced guidelines to control credit expansion, and when these had little effect, they announced additional measures that are likely to succeed in significantly reducing the growth rate of domestic credit and the money supply. It is anticipated that the government borrowing requirement will drop sharply in 1980, and that the Irish Central Bank will maintain a restrictive credit policy while proceeding to develop a more mature domestic money market.

J. Nicholas Robinson, Chase London

Paraguay: The New Frontier Economy

***Blake Friscia**, Chase Manhattan Bank's economist for the Western Hemisphere, recently visited Paraguay, where Chase has just opened a new branch in Asuncion. The following are his observations on prospects for the Paraguayan economy.*

Paraguay, historically a country with an isolated and sluggish economy, has entered a dynamic economic development phase. Three large hydroelectric projects underway in the Parana River region bordering Brazil and Argentina have attracted large infusions of investment capital and income. In addition, huge tracts of land are being brought under cultivation and foreign investors are helping to develop such important cash crops as soybeans, cotton, and wheat. Paraguay's potential for becoming the world's largest electricity exporter and a major agro-industrial economy has given it a frontier flavor.

The heady atmosphere reflects a real GDP growth rate that has averaged nearly 10% per year between 1976 and 1978. This compares with real GDP growth of only 4% per annum in the 1965-70 period before the hydroelectric projects were launched. For 1979, real GDP is expected to advance by an impressive 9%.

The hydroelectric potential. Three major hydroelectric projects along the Parana River—Itaipu, Yacyreta, and Corpus—will eventually produce 100 billion kilowatt hours of electricity per year. The $9-billion Itaipu construction project, which is being constructed together with Brazil, will become the world's largest hydroelectric facility. Itaipu will expand Paraguay's electric generation capacity by 40 times and will permit large electricity exports to Brazil. As for the other projects, the Yacyreta is just now being started and Corpus is in the planning stages. These smaller hydroelectric facilities are being constructed in partnership with Argentina. The three projects are important not only for the direct electricity production and the construction jobs and income that they will generate for Paraguay, but also for unleashing vast potential for energy-intensive industrial development.

The agricultural base. Agriculture dominates the Paraguayan economy, accounting for about one-third of GDP and some 95% of total exports. Traditionally, Paraguay's agricultural output has concentrated on crops such as corn and tobacco and on the raising of beef cattle. But in the past five years there has been a phenomenal increase in the production of soybeans and cotton, which have become Paraguay's leading farm exports.

Inflationary pressures. The boom in construction, higher oil prices, and imported inflation have combined to accelerate the domestic inflation rate during the past year. Previously, Paraguay's inflation was relatively moderate, with price rises averaging 4.5% per annum as recently as 1976. But the rate of price increases jumped sharply to 9.4% in 1977 and to 10.6% in 1978. And during the first six months of 1979, consumer prices rose at an annual rate approaching 15%, compared with the previous year. The inflation rate shot up even higher in the third quarter of 1979 to 33% above the year-earlier level. Paraguay's mounting inflation has led to pressures for salary increases, and last June the Government authorized a 15% increase in minimum wages. In fact, since February 1978 the minimum-wage scale has risen 45%. To counter the resulting inflationary pressures, the Government has relied on restrictive fiscal and monetary policies. The central government budget has shown surpluses since 1973, and in the first half of 1979 the excess of income over expenditures was up 12% over the previous year. The growth of money has also been constrained in 1979, rising by 25% this past June, compared with 35% a year earlier. High commercial-bank reserve requirements and other credit limits have been used to curb excessive domestic money creation.

Balance of payments and external debt. Paraguay's balance-of-payments position has generally been one of running current-account deficits that are financed with capital inflows related to the dam projects and other ventures. This has permitted a strong overall balance-of-payments position in recent years, and international reserves (less gold) have jumped from $157 million at the end of 1976 to $622 million in October 1979. Moreover, since Paraguay has a very open international economy, there are substantial foreign-exchange movements associated with unrecorded trade.

Paraguay's total external debt reached $690 million in June 1979, an increase of 3% over the previous year, but still small relative to projected GDP for 1979. The creditworthiness of the country is attested to by a relatively low external debt-service ratio of 10%-11% during the period 1975-78.

Growth prospects. The combination of the hydroelectric projects, the cultivation of new agricultural lands, and the country's good measure of political stability point to an annual growth potential of about 8%-9% for Paraguay over the next few years. Private investment capital and additional managerial resources, along with public infrastructural improvements, will be needed to realize this high-growth momentum, and inflationary pressures will have to be kept within reasonable limits. For the international business community, these prospects suggest interesting investment possibilities.

CHASE

International Finance

Vol. XV, No. 1
January 7, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

The World Economy in 1980—At Best a Major Slowdown

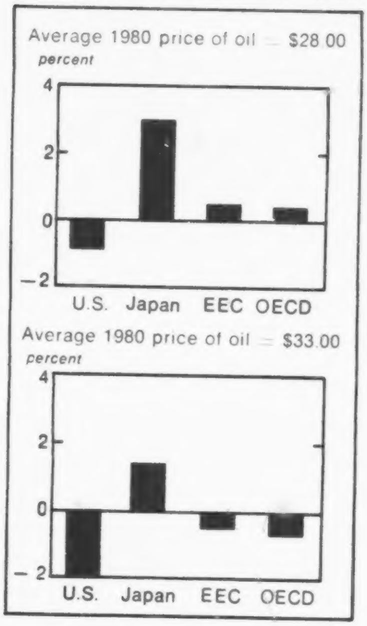
The outlook for the performance of the world economy in 1980 can only be characterized as bleak. Even under "favorable" assumptions as to the price and availability of oil, the overall growth of output in the industrialized nations is likely to be barely positive, and the volume of world trade should show little if any change.

Although among the major economies only the United States and the United Kingdom are likely to experience full-blown recessions, virtually every non-OPEC nation, developing as well as developed, will suffer a major growth slowdown. And if further developments in the U.S.-Iranian confrontation should trigger a significant squeeze on oil supplies and another major hike in oil prices, this contraction will almost certainly achieve the proportions of a world recession—with a significant drop in aggregate output in the OECD economies and an even sharper fall in the volume of international trade. Furthermore, these worsened growth prospects will not be accompanied by any significant improvement in the outlook for inflation. Even under optimistic assumptions about oil prices, the rate of inflation in most industrialized countries is likely to be only marginally less in 1980 than in 1979. In some—Japan and Italy in particular—inflation will accelerate somewhat.

Another disturbing element in the outlook for 1980 is the emergence of a pattern of international payments imbalances that implies not only significant funding problems for many countries, but also major stresses for the international monetary system. The prospective funding difficulties of the non-oil developing countries have been well-publicized; To avoid a major disruption in international capital markets, not only must the volume of official lending increase, particularly from multilateral organizations, but the growth plans of many developing countries will have to be scaled back.

Equally demanding of policy attention, however, is the anticipated stress on the international monetary system. The stress will arise from the desires of the OPEC nations to increase the share of non-dollar assets in their reserve portfolios and the limited willingness of foreign central banks to allow their currencies to perform reserve-asset roles. It may be possible to alleviate the stress somewhat with a new policy initiative that could take one of several forms—such as issuing indexed official debt on an off-market basis by the major oil-importing nations (defined either in SDRs or in their own currencies) to the surplus OPEC countries. Without some such innovation, the ingredients are in place for renewed instability in the foreign-exchange markets.

1980 growth projections
(change in real GNP, 4Q '79 to 4Q '80)



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WESTERN EUROPE

The European economies posted average growth of 2.3% in 1977, 3.0% in 1978, and an estimated 3.8% in 1979, but the 1980 outlook is for a sharp slowdown to some 1.5%. The anticipated decline will stem from higher oil prices and restrictive monetary policies adopted by the larger European economies to curb inflation. The slower growth may, however, permit a containment of the aggregate current-account deficit to the $20-billion level recorded in 1979 and hold the rate of inflation to its 1979 pace.

The **British** economy is expected to weaken in 1980 as a result of declining demand for U.K. exports stemming from sterling's sharp appreciation in 1979. The high rate of inflation anticipated—an average 16%—is likely to lead to some decline in sterling toward year-end, which could be reinforced by capital outflows stimulated by the recent abolition of foreign-exchange controls.

Domestic economic activity in **France** strengthened in late 1979. Inflationary expectations triggered strong demand for consumer durables and inventory building. In 1980, weaker domestic and external demand will produce real growth of less than 2.5%. Although curbing inflation will remain a priority, prices are still expected to rise at an average annual rate of 11%. And on the external front, the current account will return to deficit.

In **West Germany,** the restrictive monetary policy prevailing since mid-1979, combined with the deflationary impact of higher oil prices, is expected to restrain domestic demand. At the same time, slowdowns abroad will curb exports. Real GDP growth in 1980 is estimated at 2%, less than half that of 1979, with a recession a distinct possibility. Despite wage settlements exceeding the 4%-5% of 1979, the inflation rate will probably fall throughout 1980; still the year-average rate is projected at 5.2%. Last year saw Germany's first current-account deficit since 1965, and higher oil prices, together with the real appreciation of the DM, will further weaken the current account in 1980.

Renewed inflationary pressures have emerged in **Italy** after several years of expansionary policies. The authorities responded by tightening monetary policy in late 1979. As in Germany, real growth is expected to be halved, and further tightening or another substantial oil price hike could turn a slowdown into a recession.

Switzerland's inflation rate, currently running at 5%+, annualized, is a concern for the authorities. Although well below the international average, it is the highest recorded since 1975. In response, a further tightening in monetary policy led to sharply higher interest rates in the final quarter of 1979. Measures were also taken to bolster the franc, in sharp contrast to the situation at end-1978. In 1980, the average rate of inflation is expected to approximate the 3.6% of 1979. Domestic activity will likely weaken around midyear in response to restrictive monetary policy and the anticipated slowdown in external demand.

Developments in the **Scandinavian** economies usually lag those elsewhere in Europe, so that growth will probably continue strong through midyear. Toward end-1980, however, recessionary forces abroad will show up in falling export demand.

WESTERN HEMISPHERE

In 1980, the economies of the Western Hemisphere will be buffeted to varying degrees by the economic slowdown in the OECD countries, the rising price of oil, and the resurgence of inflationary pressure.

The outlook for **Canada** is for 1% GNP growth, with a slight decline in the rate of inflation from the 9% of 1979. The U.S. slowdown will reduce Canadian exports and help boost the current-account deficit to C$8 billion from C$7.0 billion in 1979.

In Latin America, **Brazil** is likely to be most affected by soaring OPEC oil prices. With oil imports heavy, the current-account gap could reach $12 billion in 1980, compared with $10 billion in 1979. Brazil has already adopted contractionary fiscal policies and has devalued the cruzeiro by 30%, actions that are likely to trim the rate of GDP growth to 5.5% from 7.1% in 1979. The rate of price rise could fall to 60% by year-end from near 80% as of end-1979 if policies of demand moderation are diligently pursued. But with large financing needs projected for 1980, Brazil will have to perform strongly to win the confidence of the international financial community.

Elsewhere in Latin America, **Mexico** will continue to ride its oil and investment boom; real GDP should approach 7% after 7.5% growth in 1979. But demand and supply pressures are likely to push the country's inflation rate above 20%. For **Argentina,** the major challenge continues to be the reduction of the country's high inflation rate; the goal is to lower the rate to below 100% from 140% at year-end 1979.

Among the countries of the Andean region, **Venezuela** is likely to continue on a cautious economic growth path, while higher OPEC oil prices will enhance its payments balance. **Ecuador** is faced with the task of setting economic development priorities as exploration for new oil sources intensifies. **Peru's** remarkable recovery will strengthen further in 1980, since the country is now a net petroleum exporter; but its prospects are tempered by a stubbornly high inflation rate. **Bolivia** has recently embarked on an economic stabilization program designed to correct its internal and external imbalances. And **Colombia's** economic expansion is likely to slow in the face of more restrictive credit policies. In **Chile,** the authorities will be confronted with an inflation/unemployment trade-off as they seek to cut the rate of price increase below 30%.

In the Caribbean, **Puerto Rico** will feel the pinch of declining U.S. economic activity. Since real GDP rose by a solid 5.4% in the fiscal year ended June 1979, however, the island is cushioned to absorb some slowdown in U.S. demand for its manufactured exports. In the **Bahamas** and **Trinidad,** economic activity is expected to continue brisk, buoyed, respectively, by tourism and petroleum earnings. The **Dominican Republic's** external position will continue weak, despite higher sugar prices, because of import needs associated with the country's reconstruction effort and higher petroleum costs. For **Jamaica,** 1980 promises continued austerity and foreign-exchange scarcity.

In Central America, **Nicaragua** faces the task of reconstruction and debt renegotiation, while **Honduras** should experience another year of healthy growth in the 7% range. **Guatemala's** pace of economic expansion is likely to slow from the high rate of nearly 6% attained in the previous four years. And **Panama** and **Costa Rica** are both expected to experience moderate growth, with possible inflationary pressures stemming from higher oil prices.

ASIA-OCEANIA

Japan enters 1980 with some uneasiness. Its high dependence on imported petroleum makes it especially vulnerable to oil price and supply developments, which are likely to have an adverse impact on the Japanese economy in 1980. The outlook is for slower growth with higher inflation. Real GDP is projected to rise about 4% as the economy begins to slow in the second half. Real growth in consumer spending is expected to slacken to about 3%-4%; the inflation rate is likely to climb to about 9%; and private investment will weaken from its current strong pace. Export volume is likely to accelerate as a result of the yen's weakness in 1979, but higher oil prices and relatively firm domestic demand should keep imports strong; the current account is thus expected to remain in deficit.

With world trade expected to be down next year, most Asian countries will see their balance of payments deteriorate, and some may have difficulty financing their deficits. In the newly industrialized countries, real growth is likely to be restrained. **Taiwan's** real GNP growth is projected at around 7.5%, as export growth slackens. **Korea** will continue with its stabilization program after three years of economic overheating. While real growth will drop to perhaps as low as 4%, the current-account gap is likely to exceed $4 billion. In **Hong Kong,** economic activity is likely to moderate, and the trade deficit should total slightly less than the $2 billion in 1979. **Singapore's** shift to a higher wage policy is intended to enhance productivity and contribute to more stable economic growth in the future.

The payments balances of **Thailand** and the **Philippines** should continue to worsen in 1980, with more stable commodity export prices and higher oil import prices anticipated. Real economic growth will drop to 6% and 4.5%, respectively. **Malaysia** will also experience a slowdown in real GDP growth, and its current account will move from balance in 1979 into sizable deficit. **Indonesia's** economy is buoyed by higher oil prices, and real growth is likely to be about 6.5% in 1980. Still, declining oil output and higher domestic consumption will require the Government to intensify diversification efforts. In South Asia, **India's** severe drought in 1979 is expected to curtail agricultural output, and real growth could decline to about 2% this year. With good harvests in 1979, **China's** real growth is expected to rise to about 6% in 1980. The current-account deficit, however, will be quite large and will force the Chinese to tap previously arranged credit commitments.

Australia's economy will grow about 3% in 1980, fueled by increased consumer spending, domestic and foreign investment, and strong agricultural exports. While inflation should hold at about 10%, prospects for unemployment and the balance of payments are not favorable. In **New Zealand,** a resurgence of inflation will accompany sluggish economic growth, weak exports, and reduced government spending.

MIDDLE EAST-AFRICA

The sharp jump in oil prices expanded the OPEC current-account surplus to an estimated $55-$60 billion in 1979. The surplus is expected to increase sharply again this year to between $85 and $90 billion, even without any further supply disruptions and despite expectations of reduced oil output. The bulk of the surplus, of course, will accrue to the Persian Gulf countries.

The likelihood of continued economic disruption in **Iran** into 1980 will constrain growth of imports and contribute to an enlarged financial surplus. **Saudi Arabia** will unveil its third development plan (1980-84), which should indicate whether the re-emergence of conservatism on the Arabian Peninsula has induced the Saudis to curtail growth substantially. Some of the smaller states in the region, such as **Qatar,** the **UAE,** and **Oman,** are expected to accelerate development spending in 1980. **Egypt** will continue to earn substantial income from oil, foreign remittances, Suez Canal tolls, tourism, and a good cotton crop in 1980, but will remain heavily dependent on Western aid. Economic activity in **Morocco** will continue dampened by an austerity program; it will also remain dependent on external loans and grants. In **Algeria,** however, higher revenues from hydrocarbon exports and a shift in emphasis away from import-intensive heavy industry suggest reduced external capital needs. **Tunisian** economic growth will accelerate significantly this year, led by exports and investment. **Syria's** economy is also expected to strengthen in 1980, as a result of higher oil revenues and Arab aid, while **Jordan** should see another year of steady growth. **Israel's** very high inflation rate prompted the Government to introduce austerity measures that will probably halve 1980 GDP growth to some 2.5%.

In **Sub-Saharan Africa,** the mineral-exporting countries should see strong exports this year, although current-account surpluses are likely to narrow from 1979 levels because of rising imports and invisible payments. Oil-rich **Nigeria,** whose current account posted a $2.3-billion surplus last year, should register a weaker surplus in 1980. **Gabon,** one of OPEC's smallest producers, can also be expected to hold its current account in the black. Sharply higher gold prices gave **South Africa** a current-account surplus of almost $4 billion last year and will continue to bolster export receipts in 1980. But imports will also increase, as economic growth is forecast to advance 4.5%. **Zambia's** small current-account surplus in 1979 is likely to fade in 1980, with the lifting of sanctions on Rhodesia likely to foster the inflow of much-needed imports. Among the agricultural exporters, **Kenya, Ivory Coast,** and **Cameroon** will continue dependent on volatile world prices for coffee, cocoa, and tea. Even with a repeat of last year's relatively good earnings, 1980 promises continued large current-account deficits and slower real growth.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALANCE OF				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use o credit lions of
Argentina	Signs of economic slowdown after fast growth in first three quarters; inflation rate dropping.	Oct.	+ 23%	61.0	$2,260	Sept.	8,730	+ 63%	25.2	0
Bolivia	New civilian government unveils austerity program of budget/money controls and limited wage rises.	June	+ 23%	4.0	650	Nov.	152	+ 11%	2.0	19
Brazil	Cruzeiro devaluation of 30% is part of price and trade liberalization program.	Oct.	+ 20%	190.9	1,654	Aug.	9,769	0	6.7	0
Chile	Industrial production up about 9% in 1979, with manufacturing showing largest increase.	July	+ 68%	15.6	1,440	Nov.	1,811	+ 72%	6.0	178
Colombia	Massive, 42-million-ton-capacity Cerro Matoso ferronickel project given construction go-ahead.	Oct.	+ 20%	23.1	895	Nov.	3,681	+ 65%	13.6	0
Costa Rica	Government investing heavily in construction of major highway networks and housing facilities.	Aug.	+ 8%	3.5	1,650	Nov.	96	– 47%	1.3	57
Dominican Rep.	Hurricane reconstruction continues; much of damage to productive capacity already repaired.	Sept.	+ 32%	4.4	860	Nov.	209	+107%	2.1	121
Ecuador	Faster progress being made in developing oil and natural gas deposits.	Apr.	+ 19%	7.2	924	Oct.	672	+ 11%	4.4	0
El Salvador	Minimum wage in agricultural sector increased; price controls more vigorously enforced.	Mar.	+135%	3.2	730	Nov.	190	– 24%	2.4	0
Guatemala	Government cites new areas for oil exploration and exploitation, but few oil firms respond.	Dec. '78	– 5%	6.3	942	Nov.	666	– 10%	6.6	0
Honduras	Large public investments in physical and social infrastructure keep economic growth in 7% range.	May	+ 16%	1.7	570	Oct.	159	– 17%	3.1	0
Mexico	Economic output high; manufacturing and oil production rising at 10% + annual rate.	Sept.	+ 40%	92.8	1,386	Aug.	1,943	+ 8%	2.2	129
Nicaragua	Reconstruction effort begun; agriculture, source of 80% of foreign-exchange earnings, given priority.	Mar.	+ 19%	2.4	995	Nov.	110	– 66%	1.7	56
Panama	President announces eight-point program of economic development; objective is 5% GDP growth.	June	+ 20%	3.4	1,868	Oct.	131	+ 21%	1.8	47
Paraguay	Economy expanding vigorously, owing to construction and agriculture booms; inflation is accelerating.	Aug.	+ 16%	2.6	900	Nov.	627	+ 39%	12.4	0
Peru	IMF seeks end to dollar certificate sales and tax rebates for non-traditional exports.	Aug.	+182%	10.7	640	Oct.	975	+112%	7.8	457
Trinidad & Tobago	Agricultural output adversely affected by sugar harvest problems; industrial production strong.	May	+ 5%	3.6	3,215	Nov.	1,797	+ 3%	12.4	0
Venezuela	Higher OPEC oil price will increase export earnings and strengthen balance of payments.	July	+ 41%	41.2	3,150	Oct.	5,590	– 12%	5.5	0

COMMODITIES

Prices of most commodities are expected to weaken during 1980, owing to a deepening U.S. recession and a slowing of economic activity in Europe and Japan. As the year begins, however, economic and political uncertainties point to the possibility of extremely volatile market conditions. On a fourth-quarter to fourth-quarter basis, average **oil** prices may increase as much as 15%, but most of this increase is already behind us. This assumes no major squeeze on oil supplies resulting from an intensification of the U.S.-Iranian confrontation.

Precious metal prices, driven skyward by the return to double-digit inflation and political uncertainties, are all susceptible to sharp corrections. Investment demand for **gold**, **silver**, and **platinum** could decrease as U.S. inflation begins to decelerate—especially if the dollar strengthens—while severe industrial supply shortages of silver and platinum appear to have ended.

Among the base metals, **zinc** is suffering from excessive inventory accumulation because of sluggish auto demand, and further downward pressure on already-low prices is expected. **Lead** prices have begun to turn down from record levels, and barring a resumption of heavy purchases by the Soviet Union, they should continue to decline as the U.S. auto slump spreads abroad. **Copper** prices have been pushed up by a spillover of speculative demand from the precious metals market. An expected decline, however, could be interrupted by a U.S. copper workers' strike at midyear when current contracts expire. Passage of legislation authorizing the sale of excess **tin** from the U.S. strategic stockpile should add to the downward pressure on prices resulting from weakening demand. Market prices for **aluminum** are also expected to weaken, but declines will be limited by the high energy costs of marginal producers.

Assuming both more normal grain crops in the Soviet Union and increased acreage in the United States, prices of **corn**, **wheat**, and **soybeans** are expected to fluctuate around their year-end 1979 levels. Little change is also foreseen for **pork** and **poultry** prices, owing to ample supplies, and with the rebuilding of cattle herds after four years of liquidation, increases in **beef** prices this year should be less than half those of 1979.

Coffee and **cocoa** prices should drift downward as a result of higher production and growing surpluses, despite market actions by producing countries. **Tea** prices, however, could increase from current low levels because of the recent drought in India. **Sugar** prices could also rise, owing partly to the likelihood of the first drawdown in world raw sugar stocks since 1972-73.

Prices of **cotton**, **wool**, and natural **rubber** will weaken in 1980, reflecting declining demand. But any such declines will be moderated by the sharply higher cost of producing synthetic, petroleum-based substitutes.

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
MF nil- ollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	January 2, 1980		current monetary conditions	
	Record inflow of foreign loans.	Nov.	+150%	Sept.	+184%	18.00%	.00065	Some easing of peso lending rates.	**Argentina**
	Peso devalued 25% in effort to close widening trade gap.	Aug.	+ 17%	July	+ 3%	—	.0520	Monetary policy is restrictive.	**Bolivia**
	Withholding tax rebate raised to 95%; import and loan deposits removed.	Nov.	+ 68%	June	+ 48%	33.00%	.0250	Credit subsidies reduced.	**Brazil**
	Price rises boost copper export earnings.	Oct.	+ 37%	Aug.	+ 48%	—	.0275	Domestic interest rates stabilize.	**Chile**
	Coffee export volume for Jan.-Oct. 1979 up 34% from year-earlier level.	Sept.	+ 26%	Sept.	— 27%	20.00%	.0265	Credit crunch prevails.	**Colombia**
	Trade deficit widening; expected to exceed $500 million.	Aug.	+ 9%	Aug.	+ 42%	8.00%	.1200	Credit to private sector restrictive.	**Costa Rica**
	Capital inflows reducing 1979 current-account gap to some $300 million.	May	+ 6%	July	+ 6%	—	Par	Credit growing in line with increased demand.	**Dominican Rep.**
	Spot oil price reaches $45 per barrel.	Sept.	+ 9%	June	+ 40%	8.00%	.0400	Bank reserve requirements cut.	**Ecuador**
	Coffee exports in 1979 up 30% above previous year's level.	Aug.	+ 7%	Aug.	+ 4%	—	.4030	Credit policy restrictive.	**El Salvador**
	Nickel exports in first ten months of 1979 double year-earlier level.	Aug.	+ 10%	Aug.	+ 33%	—	Par	Credit is scarce.	**Guatemala**
	Current-account deficit continues to widen.	July	+ 9%	Apr.	+ 17%	4.00%	.5025	Access to foreign credit eases internal credit crunch.	**Honduras**
	Larger trade deficit offset by capital inflows.	Sept.	+ 18%	Aug.	+ 28%	4.50%	.0450	Slight reduction in money supply growth.	**Mexico**
	Negotiations begun to reschedule external public debt.	Sept. '78	+ 4%	Apr.	+ 45%	—	.1030	Credit is scarce.	**Nicaragua**
	Panama Canal tolls increased 29.5% in October.	July	+ 9%	June	+ 8%	—	Par	Slow growth in domestic credit.	**Panama**
	Large capital inflows spurred by hydro-electric projects.	Sept.	+ 34%	June	+ 20%	—	.0081	Limits placed on credit expansion.	**Paraguay**
	Import liberalization stepped up; export growth continues at record levels.	Aug.	+ 65%	July	+ 37%	29.50%	.0045	Liquidity growth is excessive.	**Peru**
	Oil price increase will boost export earnings.	Sept.	+ 17%	June	+ 34%	6.00%	.4300	Some restraints on bank lending.	**Trinidad & Tobago**
	Reserves trending upward in recent months.	Aug.	+ 12%	June	+ 34%	8.50%	.2335	Commercial bank liquidity under pressure.	**Venezuela**

World Interest Rates

market rates of January 2, 1980; bond yields as of December 28, 1979

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00 penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	13.75 Jan. 3	15.00	16.00	12.35	12.375	8.10	16.00*	10.75	1.25*	8.25**
Treasury Bills 91-day, Middle Rates	12.18	13.60	15.8125	14.40 120-day	n. a.	n. a.	15.26*	no dealing	no market	5.625** 2-month
Commercial Paper prime, 3-month, asked	12.00 finance paper	14.10 finance paper 15% tax w/h	14.80	10.40 Certified	12.8125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.00	14.00 15% tax w/h	16.50	12.50 Certified	not traded	8.40	n. a.	no market	3.25* not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.07	11.62	14.32	10.40 20% tax w/h	11.83	7.85	14.03*	9.36	4.17*	8.15**
Industrial Bonds prime, long-term, new and old issues, average yield	10.35 Aa Industrials	12.00	14.89	12.07 20% tax w/h	12.92	8.09	14.41*	10.34	5.39*	6.95**
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.25	13.10	9.75	20.00*	15.50	4.00*	6.50**
Bank Time Deposits 3-month	13.125 Cert. of Dep.	13.95 Cert. of Dep.	16.875	14.45	12.875	8.95	10.75*	13.00 large deposits	6.3125* residents only	4.00** 20% tax w/h
Eurocurrencies 3-month, asked	14.0625	no market	16.9375	no market	14.00	8.375	no market	11.375	5.625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8584	2.2280	.03570	.2482	.5827	.001248	.5289	.6330	.004200
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.65 *P*	2.80 *D*	.20 *D*	FLAT	5.70 *P*	3.50 *D*	2.50 *P*	8.80 *P*	5.90 *P*

Eurodollar Deposits

(London, interbank, bid)
January 3

7-day	14.0625
1-month	14.50
3-month	14.5625
6-month	14.5625

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .62
U.S.-Canada Treasury Bills	−1.44
U.S.-Canada Finance Co. Paper	−2.56
Eurodollars-U.K. Local Auth. Deposits	+ .11

Eurbonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.75
Over 7 yrs.	12.00
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	8.25

Gold Price

London
afternoon fixing

559.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market Rates as of Dec. 19; bond yields as of Dec. 14, 1979. ** Market Rates as of Dec. 26; bond yields as of Dec. 21, 1979.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.6 (Nov.)	9.4 (Nov.)	17.4 (Nov.)	12.8 (Nov.)	5.3 (Nov.)	18.7 (Nov.)	5.2 (Nov.)	4.2 (Oct.)
Industrial production*	0.7 (Nov.)	−0.8 (Nov.)	3.4 (Oct.)	3.1 (Oct.)	4.2 (Oct.)	3.6 (Oct.)	4.0 (Sept.)	8.0 (Oct.)
Trade balance† *(billions of local currency units)*	−$1.42 (Nov.)	C$.326 (Oct.)	−£.05 (Nov.)	−FF1.28 (Nov.)	DM1.51 (Nov.)	−Lit10 (Oct.)	−SF.386 (Nov.)	−¥546 (Nov.)
Money supply (M_1)*	5.1 (Nov.)	8.5 (Oct.)	14.9 (Oct.)	12.0 (Aug.)	6.0 (Aug.)	19.9 (June)	6.8 (Aug.)	8.4 (Oct.)
Velocity of money (M_1)*	6.6 (June)	5.8 (June)	−2.1 (Mar.)	11.5 (Sept.)	−0.3 (June)	−2.2 (Mar.)	n.a.	−1.4 (June)
Reserves minus gold *($ million, change from previous month)*	+1,350 (Nov.)	−35 (Nov.)	+249 (Nov.)	+661 (Oct.)	+3,445 (Nov.)	−44 (Nov.)	+562 (Nov.)	−3,120 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The U.S. Economic Outlook

There was little economic growth in the United States in 1979—less than 1%, measured from fourth quarter 1978 to fourth quarter 1979. Some sectors of the economy weakened significantly during the year, and the weakness appeared to be spreading as the year ended. Most economists now expect outright declines in U.S. economic activity through most of 1980. The key reason: a persistent rise in consumer prices at annual rates of about 13%, which has eroded consumers' real purchasing power. In addition, high interest rates—partly a policy response to inflation— have restricted housing construction. And the sharp increase in gasoline prices, along with temporary shortages, has cut demand for large U.S.-made automobiles.

Sales of automobiles (including imports) totaled 11.2 million units in both 1977 and 1978; they began 1979 at an even higher rate. But rising gasoline prices, fears of gasoline shortages, and the weakness in real consumer income combined to reduce the sales rate sharply as the year advanced; for the last three months of 1979, the annual sales rate was about 9.3 million. Total sales were 10½ million units in 1979, with an additional drop of a million units or more expected in 1980. Virtually all the decline has been (and will be) experienced by U.S.-made vehicles. Sales of imported cars—mostly small, fuel-efficient models—have continued strong. Sales of consumer products other than automobiles held up reasonably well during 1979, but exhibited little growth in real volume. Modest declines appear likely in early 1980, with some recovery possible late in the year.

Capital investment has presented something of a mixed picture. Rising interest rates pushed construction of new housing down throughout 1979. The very large increase in rates beginning in early October further depressed the market. Construction was started on about 1¾ million new housing units during 1979, down from 2 million in both 1977 and 1978. But the rate of new starts was falling sharply as the year ended; they seem likely to total 1.45 million units or less in 1980. Capital spending by business meanwhile showed a solid gain for the year, although investment in new trucks and cars declined. Orders for capital equipment did, however, appear to be slipping toward year-end.

Opinions vary as to the probable severity of the recession that appears to be developing in the United States. Most economists expect it to be relatively mild, primarily because of the absence of the kind of speculative excesses that preceded the exceptionally severe 1974-75 recession. In particular, business inventories have been held under tight control, so that any necessary adjustment in that sector may be relatively modest.

Perhaps the greatest unknown (aside from oil-related matters) concerns the outlook for inflation. Recessions usually produce some temporary easing in the inflation rate. U.S. prices will continue to rise rapidly this winter, but there is considerable hope for a drop to lower rates in the late spring or summer. Along with a decline in interest rates, this would permit some improvement in real incomes and could help set the stage for a general economic recovery beginning later in the year.

Inflation will, however, remain a major domestic problem. Wages and salaries will probably increase even more in 1980 than in 1979. This could pave the way for a return to more rapid price inflation in the future, unless the tendency is countered by a continuation of current, relatively conservative monetary and fiscal policies. It may be difficult to stay with such policies as the unemployment rate rises over the course of the year.

Interest rates to decline slowly

The 1980 interest rate outlook hinges—as is generally the case—on the interaction of unemployment, inflation, and Federal Reserve policy. Two of these have been assessed above. First, the rate of unemployment is expected to begin rising as the economy weakens, but increases will be on the moderate side. Second, inflation conditions will not improve appreciably until around midyear. And even after that, the limited extent of the recession, plus persistent cost pressures (particularly from labor and energy), will impede any material slowing of inflation in the latter part of 1980.

In this environment, Federal Reserve policy will have to take account of difficult and interrelated problems with the dollar and inflationary expectations. The dollar is likely to be under pressure during much of 1980, despite some improvement in the U.S. trade deficit (chiefly in the first half) and a better inflation record (mainly in the second half). The tendency for dollar weakness will reflect sustained high interest rates abroad and the prospect of some further shifts in currency preferences of OPEC members and others.

Inflationary expectations in the United States seem to have become deeply ingrained in economic sentiment. To be sure, it is virtually impossible to estimate how intractable these expectations have become. But—at a minimum—to avoid validating pessimistic views that inflation may *never* abate appreciably, the Federal Reserve will be obliged to exercise caution in moving toward monetary stimulus in response to the slowing economy and concomitant slower money growth. And the risks of aggravating dollar weakness similarly will point to caution in policy shifts.

The U.S. Economic Outlook *(continued from page 7)*

While it is reasonable to expect monetary policy to continue the greater emphasis on managing bank reserves and money growth announced last October, deliberate interest rate management will probably have a major role at times. The new emphasis on money growth obviously has been implemented within a much wider band of Federal funds rates than was previously the case. But the adjustment of that rate band to changed conditions is a function of discretionary monetary management. For example, assuming a long-run M_1 growth target of 4½%-6%, M_1 growth of 3% in first-quarter 1980 would not necessarily trigger an automatic adjustment of the target range for Federal funds to, say, 8%-12%. Indeed, a major uncertainty in monetary policy during 1980 will be the extent to which the Federal Reserve will tolerate money market rates that are appreciably below the contemporary inflation rate.

In brief, short-term rates are projected to decline over the course of 1980, but probably not more than 4-5 percentage points in total—and most of that after mid-1980. This view represents something of a compromise: on the one hand, rates will come down because, under similar economic circumstances in the past, they generally have. On the other hand, declines will not be so large or so early as in the past because of the problems of domestic inflation and weakness of the dollar. The most likely outlook incorporates an expectation that last November's rate peaks will not be exceeded. If something "goes wrong" in the next few months, it may well be in the direction of some combination of more sustained growth, higher inflation, and severe dollar weakness. In this case, 1980 would bring new interest rate peaks in the first half.

U.S. external-account outlook uncertain

Last year was a banner year for U.S. exporters, with exports up some 28% over 1978 levels. Were it not for the huge oil price shocks, the U.S. trade deficit would have narrowed dramatically, since non-oil imports grew only at about the rate of inflation. However, with the oil bill for 1979 about 50% above 1978, the overall deficit was reduced only by some $4 billion. Fortunately, the U.S. services surplus skyrocketed along with oil costs; it advanced by some 40%. Overall, the U.S. current account moved from a deficit of $13.9 billion to a position of near balance.

The U.S. external picture for 1980 is riddled with uncertainty. The current account is expected to continue its long climb back to surplus as a result of continued unsynchronized world growth through midyear, but OPEC pricing strategy and foreign real growth slowdowns toward year-end temper any optimism about U.S. exports during the second half. Moreover, the export slowdown is expected to coincide with U.S. import demand reversing course and picking up as the economy revives. Thus, the 1980 current-account balance could range anywhere between a deficit of $3 billion and a surplus of $5 billion.

Export growth for 1980 could drop to between 12% and 15%, with agricultural exports providing much of the momentum. Non-agricultural exports, which boomed in 1979, are expected to lag in 1980. They will be hurt badly by the slowdown in foreign growth expected for later in the year, despite the advantages associated with a competitively priced U.S. dollar and increased OPEC demand. The critical factor is the degree to which American firms have regained their competitive position in world markets during the past two years, and whether new exporters continue to exploit these markets during periods of weak domestic demand.

The import picture is blurred by the uncertain oil price outlook. U.S. oil import costs in 1980 are projected at nearly $80 billion, double the 1978 bill. While nominal non-oil imports may rise by only 6%, well below the projected inflation rate, total imports could expand 14%-15% as a result of a potential increase in the oil bill of 35%-40%. Thus, the United States will essentially be paying for more expensive energy by curtailing non-oil imports.

In the face of a widening merchandise trade deficit, the United States will again look to the services sector to generate sufficient income to shore up its current account. And indeed, earnings from direct investment, as well as receipts from such other services as transportation, should improve, albeit at a significantly slower pace. Instead of the massive increase in earnings from U.S. investment abroad chalked up in 1979, this year should witness only modest gains in this sector as foreign economic activity begins to moderate.

This year will prove to be a critical one for the U.S. external accounts. OPEC policies, recession at home and slowdown abroad, expectations of poor harvests, and other adverse influences all suggest a turning point for the U.S. external position. The problem is that these influences sometimes favor opposing external-account movements. Nevertheless, markets have in the past demonstrated great resilience in accommodating the stresses of world payments imbalances.

CHASE

International Finance

Vol. XV, No. 2
January 21, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

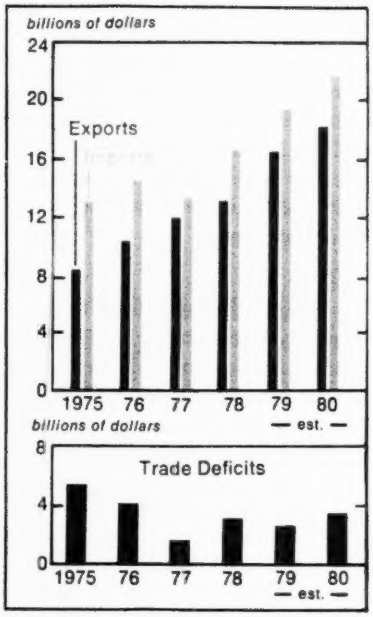
B 1900 - 1

U.S. Grain Embargo: A Squeeze on Soviet Consumers

President Carter's surprising decision to restrict U.S. grain sales to the Soviet Union has unleashed much speculation as to the impact on the Soviet economy. The limit on U.S. grain sales to the USSR is now 8 million metric tons for 1980, the maximum specified under the five-year U.S.-USSR grain agreement that expires next year. The USSR already held contracts for an additional 13 million tons and probably would have purchased a total of 25 million tons—the amount the United States made available last fall.

The embargo will have a positive impact on the Soviet foreign trade balance in 1980. Higher prices for crude oil and metals in the second half of 1979 narrowed the Soviet trade deficit with the West to an estimated $2.8 billion last year, down from $3.3 billion in 1978 and below the $3.1-$3.4 billion forecast in July. In 1980, the U.S. grain embargo is projected to reduce Soviet imports from the West by about $2 billion. Soviet demand for Western machinery and other goods is expected to remain strong, however, given the pace of Soviet investment activity coinciding with the end of a five-year plan. Overall, the 1980 Soviet trade deficit with the West is projected to reach only $3.5 billion, a level that would mean virtual balance on current account.

Soviet trade with the West



As for the impact of the embargo on Soviet meat production in 1980, livestock herds will probably decline by approximately 2% by midyear, with reductions concentrated in swine rather than cattle. Supplies of feed will fall by 5%-7% this year as existing stocks are depleted more rapidly and as Soviet farms shift toward more intensive use of pasturage. The U.S. Department of Agriculture's initial analysis that the embargo would result in a huge 13% drop in Soviet meat output appears to be an exaggeration. More likely, meat production will be 3%-4% less than otherwise in 1980-81, with higher meat imports partly offsetting the shortfall in domestic supplies.

The long-term implications of the embargo are more serious. For the United States, it will mean the narrowing of a major export market in the 1980s and the need for grain set-aside programs to maintain farm incomes. For the Soviets, it will mean less supplies of badly needed U.S. grain over an extended period. To accommodate a reduced reliance on U.S. feed grain, the Soviet leadership will have to maintain the current high share of investment devoted to agriculture. And since grain production is costly under Soviet conditions, consumers will have to accept lower meat supplies—at perhaps higher prices—as well as slower growth in the output of other consumer goods during the 1980s.

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French Government moves to ease impact of higher oil costs.

The French Government has announced proposals to help the economy adapt to oil price increases. The country's oil import bill for 1980 is estimated at FF100 billion, double that of 1978. The higher cost of crude oil has been quickly reflected in the price of refined products, including gasoline. Gas and electricity rates to domestic consumers have been boosted 11.8% and 10.8%, respectively. To ensure that industry's plans are not cut back by the higher oil prices, FF7.5 billion has been earmarked for investment aid, with FF1.5 billion of this sum to be allocated for research into energy conservation. At the same time, additional funds will be made available for the nuclear program. The measures are expected to add 0.9% to the rate of increase in consumer prices, which was running at 11.5% in November. To offset the impact of such price rises, however, the Government plans to increase social aid allocations, bringing to FF3.5 billion the total amount of such assistance provided since last August.

Economic activity in Finland likely to decline as 1980 progresses.

Latest estimates for Finland's GDP growth in 1979 are approaching 8%, and the prospect that such rapid expansion will spill over into 1980 is giving rise to concerns about possible overheating. Much of the recovery is due to a strong export performance; export volume is up 14% from last year. Average export growth for 1980 is also likely to be strong, but the economic climate is expected to deteriorate as the year progresses. Higher oil prices have more than offset the effect of buoyant exports, and the balance of payments—in surplus for the last two years—is now showing a deficit that looks set to widen over the next few months. The inflation rate has also begun to accelerate; it may reach 10% in 1980, compared with 7.4% last year. With Finland heavily dependent on international trade, its 1980 growth prospects will undoubtedly be adversely influenced by slowdowns in the remaining Western European economies.

Israeli policy of austerity may ease inflation and payments imbalances.

In late 1979, Israeli authorities were faced with two major problems. The rate of inflation had reached well over 100%, and the trade deficit of $4 billion for the year looked set to widen even further. The Government's response was to introduce corrective policy measures in November, which included a credit freeze, an increase in import duties, and reductions in price subsidies and public-sector manpower. These steps were expected to boost the consumer price index by some 20% in the short run, but there are now signs that the overheated economy is cooling off. The level of housing starts has fallen, along with spending on consumer durables. Real GDP growth in 1980 is likely to be less than half the 5% rate of 1979. If the negative consequences for employment are accepted, the measures should improve the price outlook in the medium term and help offset the impact of higher oil prices on the balance of payments.

Nicaraguan economy in the aftermath.

The recent political crisis in Nicaragua has taken a heavy toll on the country's economy. Physical damage to productive capacity is estimated at $480 million—in the context of a pre-war GDP of $2.3 billion—and led to a 25% decline in economic activity in 1979. Industry and commerce were hit especially hard; indeed, some 10% of industrial productive capacity has been lost. Agricultural capacity, the principal determinant of Nicaragua's balance-of-payments position, experienced minor physical destruction, but the losses associated with foregone production are significant. The war curtailed crop plantings sharply and prevented optimum care of existing crops; as a result, the 1979/80 crop may be 40% below the previous season's level. On the external front, the country is faced with a major liquidity crisis. Capital flight has been heavy, exceeding $300 million, and the country is saddled with $1.6 billion in external—mostly short-term—debt. Since Nicaragua is in no position to meet its external obligations, the revolutionary government is taking steps to renegotiate its debt to the international banking community.

Brazil retrenching to check inflation and external debt growth.

The Brazilian Government is faced with the formidable challenges of reducing inflation and limiting the growth of external debt. Last year Brazil's inflation rate rose to 77%—the third highest rate in Brazil's history—and its external debt topped $50 billion. In response, the Government devalued the cruzeiro by 30% in late 1979 and launched an effort to eliminate price and trade distortions in order to promote a more competitive economic system. Fiscal and monetary policies are currently more restrained and the authorities are seeking to moderate wage increases. The objective is to reduce inflation and improve the balance-of-payments position, while minimizing the cost in terms of economic growth. In 1979, real GDP grew 7%, but if the more cautious policies are adhered to throughout 1980, GDP growth could decline to some 5%. This would reduce import requirements and, consequently, external finance requirements. If Brazil succeeds in these areas, and also manages to reverse the upward trend in inflation, it will be laying a solid foundation for fast growth in the years ahead.

Philippines unveils new industrial development strategy.

The Philippines has introduced a three-pronged industrial development strategy to accelerate economic growth over the next few years. Prompted by lackluster growth of about 5% in 1979, the impact of ever-increasing energy costs, and the prospect of current-account deficits exceeding $2 billion, the Government has put forward an ambitious program aimed at relieving the structural imbalances in external payments and boosting economic growth. The program will necessitate heavy external borrowing. It consists of a $6-billion investment in large industrial projects, including copper and aluminum smelting, cement, steel, and petrochemicals; restructuring existing industry by encouraging exports rather than import substitution; and enhancing the importance and efficiency of the export sector by reducing bureaucratic red tape and providing added incentives. The three elements of the strategy, however, appear to be somewhat incompatible, and some observers feel that the large industrial projects should be scaled back. Nevertheless, the greater emphasis on exports is widely supported and could reverse the steady deterioration in the Philippine balance of payments.

Bahrainian economy poised for an upturn.

Despite declining crude production, the 1980s hold the prospect of renewed economic buoyancy for Bahrain, after the recent slowdown in economic activity. Final approval has been given for the construction of the $1-billion, Saudi-financed, causeway to the mainland. Invitations to bid have been sent out, and actual construction is expected to begin in 1981. In addition, a $70-million borrowing has been arranged for the expansion of the Alba aluminum smelter plant, while a $95-million gas-gathering and liquifaction plant opened in December. These projects, combined with the positive impact of oil price hikes on the Gulf nations, can be expected to bolster the Bahrainian economy and provide a much-needed stimulus to the construction and other service sectors—despite the current political turmoil in the region.

Nickel price outlook is bullish.

Nickel prices began 1980 nearly 50% above year-ago levels. And the outlook is for further price rises during the year, despite growing indications of a U.S. recession and economic slowdowns in other countries. Nickel consumption in the West was up by as much as 10% in 1979, the result of record demand for stainless steel and other nickel alloys. In addition, supply was restricted by a nine-month strike at International Nickel Co. facilities in Canada (from September 1978 to June 1979) and deliberate restraints on production by other major producers. As a result, previously excessive inventories have now been drawn down to below-normal levels. Moreover, while demand for nickel will weaken with a cyclical decline in capital goods and construction, the contraction in real capital spending is expected to be relatively mild, and aerospace demands should continue strong. Major producers are thus in an excellent position to weather the storm by cutting back production and adding to inventories. Indeed, producer pricing has reasserted itself in the nickel market.

A Time for Policy Reappraisal

Ever since the Great Depression of the 1930s, concern for unemployment in the United States has overshadowed concern for inflation. The enactment of the Employment Act of 1946 established the Council of Economic Advisors with the objective of achieving "full employment", and the Full-Employment and Balanced-Growth Act of 1976 (the Humphrey-Hawkins bill) reaffirmed the commitment. Nevertheless, the goal has proven elusive, as the lowest rate of unemployment consistent with a stable rate of inflation—the "full-employment unemployment rate"—has ratcheted upward.

Policymakers have felt free to focus on the unemployment problem because, until the late 1940s, inflation was a phenomenon associated primarily with war. And although the link between Federal budget deficits and inflation is not always direct, deficits also tended to occur only during time of war. Prices would generally rise rapidly during wartime, but would then fall back to their pre-war level when the fighting ended. With the cessation of war, the budget would typically return to surplus and the accumulated war debt would be gradually paid off.

After World War II, however, prices failed to fall back to their pre-war level and the accumulated Federal debt was never repaid. Although inflation continued to be a problem up until 1953, prices advanced very slowly between 1953 and 1965, and inflationary expectations receded. The apparent success of the 1964 tax cut in moving the economy toward full employment while maintaining a low inflation rate encouraged policymakers to reach into the fiscal policy grab-bag at the next sign of trouble.

In 1969, however, after several years of budget deficits associated with the Vietnam War and with unemployment below the level at which inflation tended to accelerate, higher inflationary expectations emerged. Unemployment began rising around midyear, but was still below the prevailing full-employment level of 4% by year-end; inflation was a then-high 6%. Nevertheless, fiscal policy shifted from restraint to stimulus with the Tax Reform Act of 1969. As a result, the operating budget shifted from an annual rate of $5 billion surplus in second-quarter 1969 to a deficit of $15 billion a year later. The cost of being unemployed was also reduced by the Government's extension of coverage and duration of unemployment compensation and its easing of eligibility requirements for food stamps. These actions helped ratchet up both inflationary expectations and the rate of unemployment

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE			
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Africa	Algeria	Consideration given to exporting more gas in future by pipeline and less in LNG form.	Sept.	+ 54%	19.3*	$ 1,075	Nov.	2,210	+ 76%	3.4
	Botswana	Oil conservation measures hurt agriculture, transport, and tourism.	Sept.	+ 90%	0.4	557	Nov.	272	+ 95%	5.8
	Cameroon	Domestic private investment accelerating rapidly.	Mar.	+ 6%	4.0	500	Aug.	94	— 19%	1.0
	Egypt	Negotiations with IMF resume in February for new credit; West pledges $2.5 billion for 1980.	June	+ 69%	18.8*	484	Sept.	322	— 22%	1.2
	Ivory Coast	Official estimates place 1979/80 cocoa crop at 260,000 metric tons, versus 312,000 in 1978/79.	June	+ 11%	7.6	1,440	Sept.	213	— 27%	1.3
	Kenya	Shortages of imported supplies held real growth to an estimated 3%-4% in 1979.	Feb.	– 14%	5.5	370	Nov.	635	+ 83%	4.6
	Libya	Higher oil revenues and budget outlays will accelerate economic growth in 1980.	Sept.	+ 66%	17.5*	6,635	Oct.	5,349	+ 24%	9.2
	Malawi	Gross fixed capital formation rises sharply to 30% of GDP.	Aug.	+ 35%	1.1	187	Nov.	35	+ 25%	1.0
	Morocco	EEC will reduce trade barriers to imports of Moroccan wine, tomatoes, and textiles.	June	+ 19%	12.8	678	Oct.	362	— 30%	1.4
	Nigeria	President launches $30-million agricultural crash program.	Sept.	+ 75%	41.4	520	Nov.	4,981	+208%	6.7
	Senegal	Groundnut crop in 1979 showed significant improvement over 1978.	n.a.	n.a.	2.2	400	Sept.	24	+123%	n.a.
	South Africa	Real GDP growth in 1979 estimated at 3.5%; further improvement foreseen for 1980.	Sept.	+ 45%	45.7	1,650	Nov.	997	— 10%	1.4
	Sudan	Outlook for 1979/80 cotton crop continues to be disappointing.	Mar.	+ 72%	7.1	400	Nov.	30	+ 7%	0.3
	Tunisia	Budget for 1980 will emphasize industrial development, social welfare, and education.	June	+ 39%	5.8	936	Nov.	625	+ 50%	3.3
Middle East	Iran	Oil Minister projects output of 3-3.5 million barrels oil per day this year.	Sept.	+ 3%	76.4*	2,227	Sept.	12,452	+ 8%	n.a.
	Kuwait	Crude oil output likely to be reduced during 1980.	Sept.	+ 56%	13.9**	12,278	Nov.	2,715†	+ 4%	7.4
	Saudi Arabia	Spending on infrastructure continues at a high level.	Sept.	+ 80%	54.5**	8,400	Nov.	18,502†	— 5%	9.8
	United Arab Emirates	Federal budget for 1980 set at $3 billion, up 16% from 1979.	Sept.	+ 55%	13.2*	17,820	Nov.	1,098†	+ 62%	2.5

*1977 **FY 1977/78 †Excluding State reserves consistent with non-accelerating inflation.

In political terms, commitment to fighting recession rather than inflation is often appealing. The effect of a tax cut on real disposable income is immediate, allowing current levels of consumption, production, and employment to be higher than otherwise. The inflationary effect of a tax cut, on the other hand—assuming at least a partially accommodating monetary policy by the Federal Reserve—shows up much later.

New troubles came at the end of 1973 with the oil embargo and the subsequent quadrupling of energy prices. The increase in the relative price of energy reduced the level of potential output. But policymakers attempted to offset much of this loss in potential output by pursuing stimulative fiscal policies in the wake of the 1973-75 recession. At about the same time the economy was turning the corner on its own in early 1975, a huge tax cut package was implemented. Further extensions of the coverage and duration of unemployment compensation were legislated as well. So the full-employment unemployment rate and expectations of future inflation were increased once again.

Addtional output has accompanied the forces leading to inflation in the past. Hence, most economists agree that reducing inflation will not be costless. A sufficiently stringent monetary policy could offset the stimulative effects of fiscal policy to a great degree; the process might well involve lower levels of economic activity than would otherwise have occurred in the short run.

To reduce actual and expected inflation permanently, society's faith in the future must be restored. Legislative actions to ameliorate the effects of past business downturns have made accumulating debt less risky for households, encouraging a "buy now" attitude that recently has worsened inflationary pressures. It may well be that these attitudes can only be changed if government announces and adheres to new fiscal and monetary policies consistent with lower inflation. In this context, the recently adopted operating strategy of the Federal Reserve seems to be on the right track.

Policy measures to encourage saving, such as the removal of interest rate ceilings on individuals' deposits in banks and thrift institutions, would also be beneficial. These policies would be aided substantially by an easing of the Federal deficit. Indeed, after this year's recession-induced deficit, economic recovery and continued monetary and fiscal responsibility could swing the budget firmly toward surplus. This would reduce actual and expected inflation and eventually lower the full-employment unemployment rate.

Clearly, the policies of the last fifteen years will not be easily undone, and progress is likely to be painfully slow. But the costs of delaying—in terms of accelerating inflationary expectations and rising unemployment—will only increase.

Douglas L. Bendt

F PAYMENTS		MONEY AND BANKING							COUNTRIES
f IMF , mil- dollars	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
		latest data	consumer prices	latest data	domestic credit	January 16, 1980			
0	Oil price at $33/barrel as of Jan. 1, up 10% from mid-December.	Dec. '78	+ 17%	July	+ 30%	—	.2750	A $28.5-million Euroloan obtained for dam construction.	Algeria
0	Strong diamond and meat prices boost export receipts.	Oct.	+ 15%	Oct.	—100%	5.75%	1.3150	Interest rates cut to stimulate agricultural investment.	Botswana
3	Oil refinery completion within year should swing oil account to surplus.	May	+ 5%	Aug.	+ 24%	—	.0050	Credit restraint continues.	Cameroon
1	Oil prices raised 23%; oil now provides 50% of merchandise export earnings.	Sept.	+ 14%	Sept.	+ 63%	9.00%	1.45	Money supply growing rapidly.	Egypt
0	Terms of trade expected to continue deteriorating through 1980.	Aug.	+ 22%	Aug.	+ 27%	8.00%	.0050	Money supply falls.	Ivory Coast
1	Current-account gap estimated to have shrunk to $400 million in 1979.	Aug.	+ 7%	June	+ 18%	—	.1415	IMF pressure to devalue shilling being resisted.	Kenya
0	Oil prices raised $4.72 since mid-December to $34.02-$34.72 per barrel.	n.a.	n.a.	Sept.'78	+ 9%	5.00%	3.41	A $1-billion investment company to be set up with Kuwait.	Libya
9	Higher capital-equipment imports and lower tea prices widen trade deficit.	Sept.	+ 14%	Oct.	+ 50%	8.00%	1.27	Credit continues restrictive.	Malawi
6	Imported oil bill rising rapidly.	Mar.	+ 10%	Sept.	+ 20%	4.50%	.2750	Loan of $15 mn. obtained from Islamic Development Bank.	Morocco
0	Oil price of $30/barrel will raise 1980 gross oil receipts to $25 billion.	May	+ 8%	July	+ 14%	5.00%	1.88	Large foreign-exchange inflow boosts money supply.	Nigeria
9	Trade gap in 1979 unlikely to have narrowed from $280 million in 1978.	Aug.	+ 13%	July	+ 31%	8.00%	.0050	Credit restraint continues.	Senegal
7	Current-account surplus estimated at $4 billion in 1979.	Oct.	+ 14%	Sept.	+ 10%	7.00%	1.2250	Credit remains readily available.	South Africa
4	Current-account deficit remains above $500 million.	Mar.	+ 27%	Sept.	+ 22%	—	2.01	Foreign-exchange controls eased significantly.	Sudan
1	Oil revenues rising sharply.	Sept.	+ 10%	Sept.	+ 11%	5.75%	2.63	Euroloans of $42.5 million obtained for phosphate and oil.	Tunisia
0	Oil contracts with several countries call for average price of $30/barrel.	Sept.	+ 10%	May	+ 30%	9.00%	n.a.	Money supply declined during first half 1979.	Iran
0	LPG prices raised 6% in December, fourth consecutive monthly increase.	June	+ 4%	Sept.	+ 54%‡	—	3.69	Proposal to denominate contracts in dollars, vs. KDs.	Kuwait
0	Agreements with foreign firms pending to refine and market oil in the West.	Sept.	+ 2%	July	+ 40%‡	—	.3000	Bank credit to private sector expanding steadily.	Saudi Arabia
0	January Abu Dhabi oil prices up 28% from October.	n.a.	n.a.	Sept.	+ 23%‡	—	.2700	UAE Supreme Council approves bill to create central bank.	United Arab Emirates

‡Private sector only

World Interest Rates

market rates of January 16, 1980; bond yields as of January 11, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00 penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	13.50 Jan. 17	15.00	23.50	12.50	12.125	8.60	16.00	11.25	0.875	8.6875
Treasury Bills 91-day, Middle Rates	11.80	13.50	15.625	14.40 120-day	n. a.	n. a.	14.412 74-day	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	12.00 finance paper	13.95 finance paper 15% tax w/h	14.81	10.40 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.90	13.90 15% tax w/h	16.25	12.50 Certified	not traded	8.40	n. a.	no market	3.25 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.35	11.87	13.82	10.51 20% tax w/h	11.78	8.20	13.94	9.34	4.29	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	11.85 Aa Industrials	12.17	14.91	12.35 20% tax w/h	12.93	8.07	14.19	10.31	5.35	6.94
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.25	13.10	9.75	20.00	15.50	4.50	6.50
Bank Time Deposits 3-month	13.125 Cert. of Dep.	13.85 Cert. of Dep.	16.75	14.45	12.50	8.65	10.75	12.00 large deposits	5.3125 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.125	no market	17.00	no market	13.00	8.25	no market	11.125	5.1875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8576	2.2730	.035642	.2461	.5775	.001239	.5230	.6260	.004183
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.37 *P*	2.45 *D*	.10 *D*	.80 *P*	5.75 *P*	9.00 *D*	2.75 *P*	8.75 *P*	6.10 *P*

Eurodollar Deposits

(London, interbank, bid)
January 17

7-day	13.6875
1-month	13.875
3-month	13.9375
6-month	13.875

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.16
U.S.-Canada Treasury Bills	−1.45
U.S.-Canada Finance Co. Paper	−2.13
Eurodollars-U.K. Local Auth. Deposits	− .30

Eurbonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.60
Over 7 yrs.	11.70
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	7.875

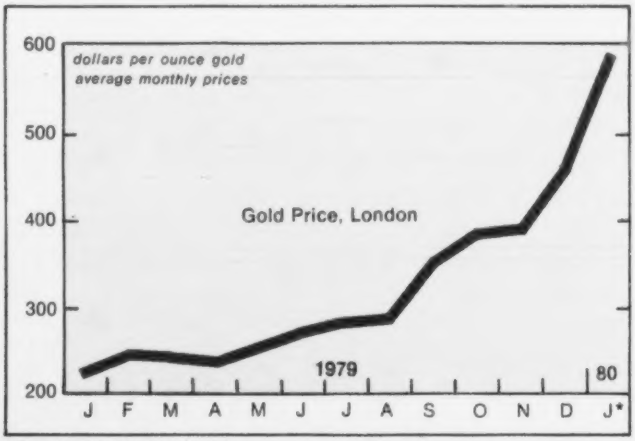
Gold Price

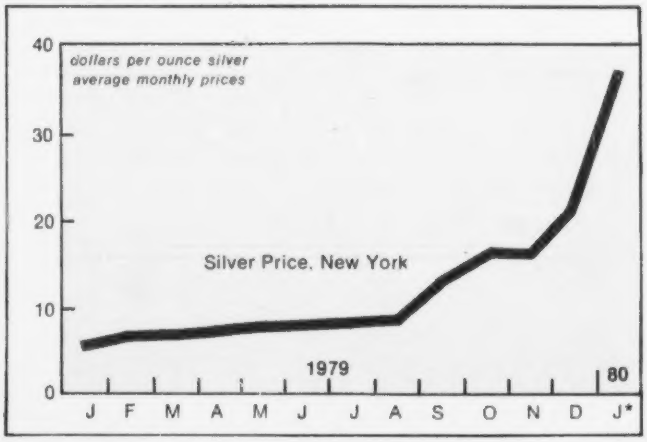
London
afternoon fixing

760.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Gold and silver price rises accelerate





** Based on first two weeks data*

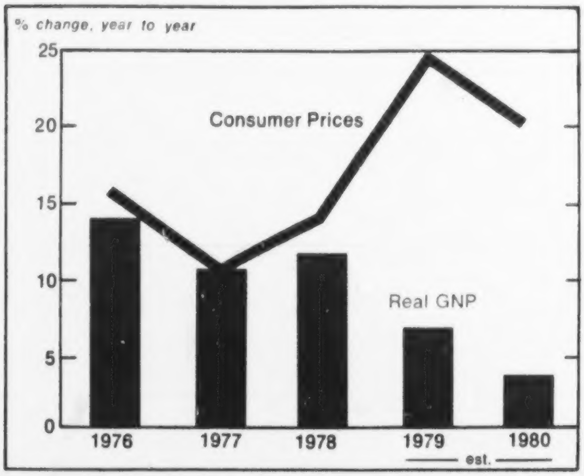
Korean Economy in Transition

The death of South Korean President Park Chung Hee last October 26 ended an 18-year regime that brought immense increases in Korea's wealth and influence in the world. Between 1976 and 1978, when already expansionary policies were intensified, real GNP soared 39.4%—an average of 11.7% per year—while exports rose 254%, from $5 billion in 1975 to $12.7 billion in 1978.

Over the course of this three-year period, however, the economy began showing signs of structural distortion and strain. The economic overheating prompted the Park Government to introduce an ambitious economic stabilization program in late 1978, although in the months prior to Park's death some elements of the austerity program were slackened in response to political pressure. Still, the interim Government of Choi Kyu Hah has promised continuity in the stabilization effort. The devaluation of January 12, together with other measures taken concurrently, demonstrate that the transition in political power has not precluded decisive economic policy action.

Economic policy under Park

During the 1976-78 period of especially rapid growth, a cornerstone of the expansion was a huge government-sponsored program of investment in heavy industry, featuring expansion of steel, petrochemical, and machinery capacity. The rationale was that Korea could not depend indefinitely on labor-intensive light industry as living standards and wage costs rose. However, at the same time the heavy-industry program was proceeding, output in all the older export industries was being pressed to a maximum, supported by government policies of easy credit. As a result, unemployment nearly disappeared and shortages of skilled labor emerged, which began to hinder the performance of several key industries.



Money supply and wage rates soared, and the inflation rate accelerated to over 14% in 1978, despite a broad range of price controls. The current account, which shifted from a deficit of $313 million in 1976 to a surplus of $12 million in 1977, posted a deficit of over $1 billion in 1978.

The emerging strains led the Park Government, following the election of December 1978, to pursue a policy of stabilization. Investment programs were either cut back or deferred, especially steel expansion plans. The economic growth target was lowered to the 8%-9% range, and credit restraints were introduced to support a target of 25% for money supply growth in 1979—although government-controlled interest rates were not permitted to increase. The government budget was to be shifted into surplus, partly by limiting wage increases of government employees to 15%.

When it became apparent that the program might be too harsh—as manifested by the insolvency of a major trading firm and the threat of other bankrupcies—several aspects were modified. Credit availability was eased selectively, and a proposal to trim the subsidized rate for exports (9%, compared with a prime rate for domestic borrowers of 18.5%) was shelved. In addition, the farm support price of rice was boosted 22%, which ensured the continuation of a large extra-budgetary Grain Management Fund deficit. As a result, the money supply increase for 1979 came in at around 30%, 4-5 percentage points over target, while the government budget was just barely kept in balance. Real GNP growth in 1979 is estimated at 7.1%, and consumer prices increased by approximately 25%.

Balance of payments deterioration

South Korea registered a sharply increased balance-of-payments deficit in 1979. Preliminary figures indicate that the trade deficit reached $4.3 billion and the current-account deficit, $3.9 billion. The value of exports rose only 18.5% to $15.1 billion, falling short of the $15.5-billion target. Exports were held back by credit restraints; increasing protectionism abroad and otherwise weak foreign demand; and by a loss of price competitiveness stemming from an overvalued currency. (The exchange rate of the Korean won stood unchanged from December 1974 through 1979, despite the high double-digit inflation rates of recent years.)

On the import side, capital goods and crude oil imports rose sharply, raising total import growth to 38% in 1979, versus 37.7% in 1978. The jump in capital equipment imports was attributed to large orders placed prior to the stabilization effort. And higher oil imports were a necessary result of the emphasis on energy-intensive heavy industry development. Crude

Korean Economy in Transition

(continued from page 7)

oil imports cost South Korea approximately $4 billion in 1979, as against $2.3 billion in 1978, and oil consumption continues to outpace the growth in GNP.

The 1980 trade deficit is expected to be even larger than that of 1979. Capital goods imports will decline, but oil imports alone will cost roughly $6 billion. Exports, on the other hand, will be hurt by recession in the key U.S. market. The 16.55% devaluation of January 12, which pared the won's value from 484 to 580 per U.S. dollar, should enhance export competitiveness for a while, but unless inflation can be curbed quickly, the advantage will be eroded.

Despite the present and continuing gap in the current account, Korean foreign-exchange reserves remain adequate, at slightly over $5 billion. Still, with annual imports approaching $20 billion, they do not provide a sufficient cushion; and since the Government is reluctant to run them down, borrowing requirements are substantial.

External-account indicators

millions of dollars

	1976	1977	1978	1979 est.	1980 est.
Trade balance	−590	−477	−1,781	−4,300	−5,500
Current-account balance	−313	12	−1,085	−3,900	−4,700
International reserves	2,961	4,307	4,920	5,500	6,200

Prior to Park's death, South Korea undertook the last of a series of major syndicated borrowings for 1979. Total borrowings last year were on the order of $5 billion. The gross borrowing requirement for 1980 —including funds to cover amortization and a slight rise in reserves—is estimated at approximately $6 billion. South Korea is almost certain to turn to the International Monetary Fund for further drawings. As of end-December, its drawings totaled only $360 million against an overall IMF drawing potential of nearly $700 million.

Although external borrowing requirements will continue heavy this year, South Korea's external debt is expected to remain of reasonable size relative to GNP and export earnings. The debt-service ratio, 10% in 1979, is not likely to exceed 11% this year. Thus, the country will probably continue to enjoy a high credit rating with foreign lenders, particularly U.S. banks, which are its chief sources of commercial credit. This, however, will depend upon whether the current interim government maintains order in the transition of political power.

The outlook through 1981

The recent devaluation is only part of a package of measures that includes budget cuts and sharp increases in interest rates. Taken together, these actions constitute a tough program designed to pull down the inflation rate to more manageable levels, almost certainly at the cost of reducing GNP growth and raising the level of unemployment. This is hardly likely to be a popular policy, and its adoption shows not only decision-making unity within the Government, but willingness to take political risks. Evidently, the events of mid-December, which resulted in the sudden replacement of a number of top military figures, did not destabilize the interim regime of President Choi; they may in fact have strengthened it.

In view of the new policies, 1980 GNP growth will almost certainly be low, probably not more than 4%. The new export goal of $17 billion is only 13% above 1979, with most of it likely to be inflationary rather than real growth. The 1980 forecasts are for a trade deficit of $5.5 billion and a current-account gap of $4.7 billion.

By 1981, several more favorable factors should be operating to bolster economic activity. The U.S. market should be recovering from recession, and the stabilization effort should have by then helped reduce the balance-of-payments deficit. In addition, the major capital investment programs of 1976-78 should all be completed and productive, and a new permanent government should be in a stronger position to take the measures necessary to facilitate a return to rapid growth.

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CHASE

International Finance

Vol. XV, No. 3
February 4, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

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Growth Slowdown in the Non-Oil LDCs

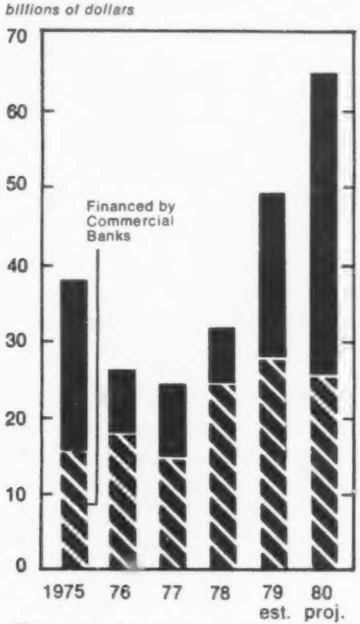
There has been much loose talk in recent months about whether "recycling is going to work for the non-oil LDCs this time around." Stated this way—with the implication of deficits too large to be financed—the question has no meaning. A deficit that cannot be funded cannot exist. Rather, the appropriate questions are: First, whether countries whose future growth is now limited by tighter foreign-borrowing constraints will recognize the dimensions of these limitations and adjust their policies accordingly—or whether they will postpone adjustment until forced by disruption of capital flows; and, second, whether the anticipated growth performance of the developing economies implied by these new constraints is acceptable to potential suppliers of official aid or credit.

These questions must be posed on a country-by-country basis. The recent unsettling events in the Middle East and increased pessimism with respect to the long-term trend in oil prices have probably resulted in some generalized reduction in the willingness of banks to make foreign loans. However, the expected tightening in overseas bank lending is primarily a matter of changes in bank perceptions of the debt-service capability of particular countries—or the worrisome increase in the ratios of certain developing-country debts to total bank capital.

A survey of the countries whose external-debt positions and long-run growth objectives suggest a particular vulnerability to external funding constraints indicates that most are already in the process of significant adjustment. In some cases, however, much more needs to be done. Thus, although problems will undoubtedly emerge, there is currently no basis for the prediction that the adjustment process is being so generally delayed in the non-oil LDCs that something approaching a synchronized interruption of debt service will result.

The reduction in growth rates implied by this scenario is severe, however, particularly in the export-oriented "newly industrialized economies." Growth over the next year or two in these countries will probably be no more than half the rate achieved in recent years. The slowdown in the so-called "middle-income" developing economies will be less pronounced but still significant for the vast majority. Unlike the world recession of 1974-75, the non-oil developing nations will be full-fledged partners with the developed countries in the forthcoming world economic slowdown.

Current-account deficits* of non-OPEC LDCs



* Before official transfers

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Austrian growth forecasts revised downward, but inflation to accelerate.

Since the end of 1978, Austria has lost about $1.5 billion in foreign-exchange reserves as a result of rising German interest rates. To protect the schilling, which is effectively tied to the German mark, Austria's central bank has adopted a more restrictive monetary policy. The basic discount rate was raised 1.5 percentage points to 5.25%; the supplementary discount rate (applicable to the last 30% of bank discount quotas) was boosted to 6.25%; and the penalty rate for banks failing to satisfy reserve requirements was doubled to five percentage points above the basic discount rate. At the same time, current-account-balance prospects are constrained by weak real growth in Germany and higher oil prices. The current-account deficit is forecast to widen to 31 billion schillings from 25 billion in 1979. As for real GDP growth, forecasts have been revised down to 2.2%-2.5%, after 5% growth in 1979, while the inflation rate is expected to rise to an annual average of 4.8% in 1980, versus 3.6% last year.

Norway striving to enhance international competitiveness.

Norwegian economic growth is set to accelerate in 1980, stimulated by the country's oil and shipping sectors, which should contribute some 2% to GDP growth. Progress in these two industries will also sustain the steady improvement in the current-account balance, and help pare the current-account deficit to about $1 billion from $1.5 billion in 1979. With the outlook for traditional manufacturing industries dimmed by slowdowns in the economies of major trading partners, Norway's economic policy is now geared to enhancing the international competitiveness of traditional mainland industries. The system of selective supports for individual firms is being dismantled in favor of more generalized policy measures. But perhaps most critical is the outcome of the 1980 wage negotiations and prospects for inflation. September 1978 marked the beginning of a period of very restrictive wage and price controls, which saw the rate of increase in wages drop to about 4.75% and the rise in consumer prices to 4.8% over the course of 1979. The Government hopes that a continuation of price controls, plus reduced support for industry, will produce lower wage settlements and curb inflation.

Inflation-control a problem for Mexico's booming economy.

Mexico led the major Latin American economies in real GDP growth last year, posting an impressive 8% gain. Spurred on by substantial rises in oil output to about 2 million barrels per day as of end-1979, Mexico's industrial and construction sectors progressed vigorously. Only agriculture, troubled by drought conditions, failed to share in the overall rapid growth. This rapid demand expansion, however, has accelerated inflation; the average 1979 retail price index was up 18% over 1978. The strong economic advance is expected to continue in 1980, but inflationary pressures will mount. A new value-added tax is estimated to add 3% to inflation this year, while agreement has been reached to allow a 21.5% increase in the average national minimum wage during 1980, roughly in line with anticipated inflation. To slow recent large rises in the money supply and inflation, the central bank has raised minimum reserve requirements for commercial banks, but controlling inflation will be difficult in the face of an expansive fiscal policy and real growth of more than 7%.

Gold boom a boon to South African economy.

The sharp run-up in gold prices will have a significant effect on South Africa's economy in 1980. In the domestic sector, treasury revenue from gold for fiscal 1979/80 (ending June 30) will probably reach $2 billion, as against the budgeted $900 million. This added revenue will enable the Government to meet its commitment to encourage private-sector growth. Tax cuts of 5%-10% for individual taxpayers will very likely be included in the upcoming March budget, in addition to tax incentives to stimulate private fixed investment. The Government may also abolish the loan levy and the 7.5% import surcharge. Removal of the latter would lower the rate of inflation, which is expected to reach 15% this year, up from 13.5% in 1979. Some of the revenue overflow may also be directed to capital projects serving the black community. On the external front, anticipated higher imports associated with accelerating growth will reduce the $4-billion current-account surplus of 1979; but thanks to increased gold earnings, the surplus should still remain at more than $2 billion this year, even assuming a conservative $400 per-ounce average gold price in 1980.

Japanese economy to weaken, but exports will revive.

Japan's economy is set for a slowdown in fiscal 1980/81 (beginning April 1). Consumer expenditures will continue to decline, owing to rising inflation and relatively small wage increases. And growth in private investment, rising about 15% in the current fiscal year in nominal terms, is expected to fall to some 7% next year as a result of declining corporate profits, high interest rates, and relatively restrictive monetary policy. In addition, government expenditures are slated to rise by a conservative 10.3%, the lowest growth rate in twenty years, while public loan and investment programs are estimated to increase a nominal 8%—or not at all in real terms. The one bright spot is exports. Export volume is likely to advance 8%-9% because of increased price competitiveness stemming from the yen's depreciation in 1979. Moreover, the domestic slowdown is likely to fuel a renewed export drive; the contribution of exports to GDP is projected to rise to 30% from 10% in FY 1979/80. Overall, real growth is expected to fall from this fiscal year's estimated rate of 6% to about 4% in FY 1980/81.

Singapore hopes for a second industrial revolution.

Singapore's economy is undergoing fundamental change to better position it to meet the economic challenges of the 1980s. The Government estimates that of the 7% average annual growth achieved between 1974 and 1979, productivity growth accounted for only 3%. Labor force growth made up the remaining 4%, 2.5% of which derived from neighboring ASEAN countries. Given Singapore's delicate population and communal balance, this heavy dependence on labor—particularly foreign—was regarded as unhealthy. Accordingly, the Government adopted a new industrial plan in 1979 aimed at enhancing productivity. The plan consists of a high-wage policy; upgrading the technology embodied in labor; and providing added incentives for capital and technology transfer from abroad. The strategy is expected to minimize competition with Singapore's less developed neighbors, while maximizing the complementarity of economic structures. If the plan is executed with minimal distortion to the socioeconomic framework, the official average annual growth target of 8% for the 1980s may be achieved.

Turkey steps up austerity.

With November consumer prices 75% above their year-earlier levels, Turkey's new government moved to announce further austerity measures, despite real GDP growth of less than 1% in 1979. The lira was devalued from 47.1 to 70 per U.S. dollar, energy prices will be increased between 44% and 100%, and prices for the products of the nationalized industries will be boosted. To moderate the inflationary impact of the devaluation, the stamp duty on imports will be cut sharply. Finally, regulations on foreign direct investment are being liberalized. The economy did experience improvement on the external front in 1979. The current-account deficit was $1.06 billion, down from $1.33 billion in 1978, and Turkey managed to reschedule some $3 billion in foreign debt. In 1980, however, the current-account gap is expected to exceed $1.8 billion. Total imports are likely to hit $7 billion, with oil imports alone about $4 billion. Export earnings, on the other hand, are officially forecast to reach only $3.5 billion, at best. With Turkey due to repay some $860 million in foreign debt this year, total new foreign-exchange needs will exceed $2.6 billion, as against $1.8 billion raised last year.

Sugar prices to remain firm this year.

World sugar prices have recently risen to nearly 20¢ per pound from an average of 8.85¢ in August, fueled by a fundamental shift in the supply/demand balance. World production for 1979/80 is now projected at 87.7 million metric tons, down almost 4% from 1978/79, and this, coupled with an expected rise in consumption, should result in a sharp drop in world sugar stocks this year following seven years of steady increase. An even sharper decline in stocks is possible in 1980/81. Thus, although prices are near levels that can trigger release of part of the buffer stock under the International Sugar Agreement recently ratified by the United States, and although speculative elements in the market may produce a near-term correction, sugar prices are expected to remain strong this year.

Taxes, Arms Spending, and Inflation

The budget proposed by President Carter for fiscal year 1981 sounds a lot like an incumbent politician's dream come true. Defense spending is boosted in response to the perceived new Soviet threat, while domestic spending for income security, agriculture, housing, and transportation is also higher. And the budget can still be termed "anti-inflationary", since the $16-billion projected deficit is substantially lower than the (upward-revised) $40-billion shortfall for FY 1980. Moreover, this reduction in the deficit is expected to occur despite the Administration's forecast of a slight decline in business activity and rising unemployment that will cut into receipts and raise expenditures.

The solution to this apparent paradox is higher taxes, but from either previously enacted bills or sources not directly affecting voters. Both the base wage and the rate for Social Security are scheduled to rise in 1981 by previous congressional action. These changes are estimated to increase revenues $15 billion above FY 1980. Furthermore, as nominal incomes rise to keep pace with continuing high inflation, more taxpayers are pushed into higher income tax brackets. So, barring any tax reduction, personal income taxes will still rise about 1½ times faster than personal income. For FY 1981, this "inflation tax" will generate another $15 billion or so. In addition, the net receipts from the new excise tax on domestically produced crude oil–the so-called "windfall-profits" tax–will add another $14 billion, and an accelerated schedule for tax payments will yield still another $5 billion. Overall, tax receipts are projected to grow 14½%. Expenditures, on the other hand, are scheduled to rise only 9¼%. Defense spending is projected to increase more than 12%, while other outlays are budgeted to rise by only 8½%.

Several economic analysts have expressed the concern that increased defense spending will worsen the inflation outlook. They argue that defense contractors will step up their spending for some materials, machinery, and skilled personnel currently in short supply, adding to existing price pressures. This concern, however, appears premature. During the aerospace slump in the early 1970s, many defense contractors suddenly found themselves with excess capacity. Some have since shown a preference for more stable commercial orders. As a result, any capacity expansion is likely to be cautious until the Federal commitment to higher defense spending seems lasting or until additional investment incentives are introduced.

In the event of the much more rapid military buildup that some analysts fear is necessary, the "guns vs. butter" decisions would be much harder to make. In the absence of an explicit increase in taxes or cuts in nondefense spending to pay for the higher military expenditures, the deficit would swell. The Federal Reserve might then find it more difficult to avoid accommodating the larger deficits with monetary expansion.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1978		BALANC			
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered
Austria	Economic growth set to slow sharply in 1980 from more than 5% in 1979.	Sept.	+ 9.1%	58.1	+ 1.5%	Nov.	3,634	− 17.6%	2.3
Belgium	Economic growth to weaken; large public-sector deficit limits scope for reflation.	Sept.	+ 4.5%	96.1	+ 1.6%	Nov.	6,259	+ 59.3%	1.3
Britain	Recession expected in 1980, despite small recovery at year-end 1979.	Sept.	+ 1.2%	308.2	+ 3.2%	Nov.	19,371	+ 22.8%	2.4
Denmark	Economy headed for recession as a result of restrictive fiscal policies.	Sept.	+ 3.7%	55.5	+ 1.0%	Nov.	3,124.	+ 7.6%	2.1
Finland	GDP still growing rapidly in the wake of 1979 boom.	Sept.	+ 9.2%	32.2	+ 2.5%	Nov.	1,439	+ 39.7%	1.7
France	Industrial orders remain strong, but consumer surveys indicate weakening confidence.	Sept.	+ 7.2%	470.5	+ 3.3%	Oct.	16,483	+ 91.8%	1.9
Germany	Growth forecast for 1980 being revised downward; tough wage round in progress.	Oct.	+ 4.2%	639.2	+ 3.1%	Nov.	49,032	+ 4.3%	3.9
Ireland	Government's ambitious growth targets now being scaled down.	Mar.	+ 6.7%	12.2	+ 7.0%	Nov.	2,092	− 18.9%	2.7
Italy	Economy set to slow sharply from 4%+ real growth in 1979; inflation rate approaching 20%.	Sept.	+ 7.1%	237.0	+ 2.6%	Nov.	18,576	+ 78.4%	3.1
Netherlands	Export- and investment-led slowdown forecast for 1980; inflation likely to rise to 6%.	Nov.	+ 2.2%	130.5	+ 2.5%	Nov.	7,506	+ 66.9%	1.4
Norway	Unlike most European countries, economic growth will rise in 1980—because of oil.	Oct.	+ 5.8%	39.7	+ 3.5%	Nov.	4,366	+ 72.1%	4.0
Portugal	Confidence improves following Carneiro election victory.	Apr.	+ 7.0%	18.3	+ 3.2%	Oct.	1,141	+ 25.4%	2.5
Spain	Economy slowing down; 1.5% growth expected in 1980.	June	+ 2.5%	141.2	+ 2.9%	Oct.	13,172	+ 32.7%	6.9
Sweden	Government planning public spending cuts, but GDP growth still expected to approach 3%.	Sept.	+ 9.6%	87.2	+ 2.8%	Nov.	3,491	− 15.9%	1.5
Switzerland	Growth prospects favorable for first half of year.	June	− 2.7%	84.4	+ 0.9%	Nov.	13,962	− 4.8%	5.8
Turkey	IMF-imposed credit and spending ceilings adhered to; further austerity measures forthcoming.	June	0	48.7	+ 3.2%	Oct.	895	− 18.9%	2.2
Canada	Indications of less consumer confidence in economic outlook; real GDP growth of 1% forecast.	Sept.	+ 5.1%	206.0	+ 3.4%	Nov.	2,966	− 15.5%	0.7
United States	Higher energy prices push already-fragile economy closer to recession.	Dec.	+ 0.9%	2,098.6	+ 4.0%	Nov.	8,149	+ 28.8%	0.5

A New Look at Monetary Policy

Monetary policy will be undergoing renewed scrutiny in coming weeks. The upcoming meeting of the Federal Open Market Committee, scheduled for February 5, is expected to furnish new insights into the strategy of monetary policy for 1980. And the regular congressional testimony by Federal Reserve Chairman Volcker, slated for mid-February, will provide extended discussion of current policies and their links to pressing economic questions.

Three issues will be receiving particular attention. First, it is widely anticipated that the Federal Reserve will announce a redefinition of certain monetary aggregates—ranging from M_1 and other "Ms" through broad measures of liquid assets. One uncertainty in this regard will be the extent to which "new" aggregates are a more accurate indication of developments in the economy.

The second issue, an extension of the first, deals with what new measures of control may be undertaken and how. Intuitively, there is no reason to believe newly defined aggregates will be easier to control than the old ones, given present reserve requirements and operating procedures. In fact, control may be more difficult. Moreover, the fourth-quarter 1979 experience with monetary aggregates was not a true test of the Fed's resolve to face the tactical consequences of greater emphasis on the growth of monetary aggregates. The reason for this is that fourth-quarter growth of M_1 had only to fall within a range of roughly—3% to 9% in order to be consistent with the revised 1979 growth target of 3%-6%.

The third issue relates to the role of interest rates as a policy variable. While the Fed curbed its efforts to moderate short-run variability in the Federal funds rate in its policy moves last October, it by no means abandoned interest rates as operating targets. At this stage of the cycle, when interpretation of monetary aggregates is more complex than usual, interest rates—relative to actual and expected inflation—play an important role as an indicator of policy. Under current inflation conditions, the recent Federal funds range of 12½%-14% is about even with the Consumer Price Index and a bit higher than broader inflation measures. However, this level does not reflect tax effects. As a number of analysts have pointed out, on an *after-tax* basis, interest rates are well below the inflation rate. That is, in some cases rate levels are still low enough to constitute an incentive to incur new debt.

Uncertainty over the relative weights to be accorded interest rates and money growth as policy objectives will not be dispelled in February—and perhaps not until much later in 1980. There will come a time, however, when economic conditions (including money growth) will cause the Fed to change its Federal funds targets materially. In coming weeks, the market will be looking for new evidence regarding the Fed's reaction strategy.

OF PAYMENTS		MONEY AND BANKING							
		12-month changes				central bank rate	exchange rate in U.S. dollars		COUNTRIES
f IMF t, mil- dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	January 30, 1980		current monetary conditions	
0	Hard-schilling policy maintained, despite widening current-account gap.	Dec.	+ 4.7%	Sept.	+17.2%	5.25%	.0803	Discount rate raised to 5.25%.	Austria
0	Higher oil prices all but rule out a narrowing current-account gap.	Nov.	+ 5.3%	June	+14.5%	10.50%	.03540	Monetary conditions are restrictive.	Belgium
63	Current-account deficit narrowed somewhat in recent months.	Dec.	+17.2%	Oct.	+17.1%	17.00%	2.2635	£ strong due to high rates and bull market for govt. stocks.	Britain
0	Current-account deficit of about kr. 14 billion expected in 1980.	Nov.	+ 6.0%	Aug.	+ 7.8%	11.00%	.1843	Monetary policy remains restrictive.	Denmark
87	Trade balance slipping into deficit, owing to growing import bill.	Nov.	+ 7.9%	Aug.	+12.9%	8.50%	.2712	Credit conditions tightening somewhat.	Finland
0	Strong exchange rate eroding export-price competitiveness.	Dec.	+11.8%	Dec. '78	+12.4%	9.50%	.2459	Credit demands keep short-term rates high.	France
0	Current-account gap expected to widen substantially this year.	Dec.	+ 5.4%	Sept.	+12.7%	6.00%	.5753	Bundesbank announces lower 1980 monetary target.	Germany
0	Higher oil prices weaken balance of payments.	Aug.	+13.6%	Aug.	+39.0%	13.70%	2.1330	Credit conditions restrictive; interest rates in 18% range.	Ireland
0	Large current-account surplus in 1979, but shrinkage expected in 1980.	Dec.	+19.8%	Apr.	+14.8%	15.00%	.001239	Discount rate raised to 15% in December.	Italy
0	Gas export prices being renegotiated, but energy deficit likely to persist.	Nov.	+ 4.6%	Sept.	+16.6%	10.25%	.5205	Monetary conditions continue restrictive.	Netherlands
0	Narrowing of last year's kr. 7-billion deficit anticipated.	Nov.	+ 4.6%	July	+18.4%	9.00%	.2040	Credit tightened; discount rate raised from 7% to 9%.	Norway
24	Improving payments trend of 1979 threatened by higher oil prices.	Oct.	+23.1%	July	+18.7%	17.00%	.0208	Discount rate reduced despite large budget deficit.	Portugal
59	Current account to move into deficit this year.	Oct.	+15.6%	Sept.	+15.9%	8.00%	.0153	Monetary conditions remain restrictive.	Spain
0	Estimates of kr. 3.5-billion deficit for 1979 after kr. 4.7-billion surplus in 1978.	Nov.	+ 9.5%	Sept.	+22.8%	10.00%	.2398	Discount rate boosted from 9% to 10% in January.	Sweden
0	Strong import growth eroding current-account surplus.	Dec.	+ 5.2%	Sept.	+13.8%	2.00%	.6161	Liquidity remains tight in support of exchange rate.	Switzerland
2	Lira devalued from 47.1 to 70 per U.S. dollar.	Nov.	+74.6%	Dec. '78	+26.1%	10.75%	.0145	Monetary aggregate expansion below inflation rate.	Turkey
0	Surplus in merchandise trade boosts exchange rate.	Dec.	+ 9.8%	Aug.	+25.0%	14.00%	.8608	Central bank lowers money-supply growth target.	Canada
0	Current-account balance remains strong.	Dec.	+13.3%	Dec.	+11.4%	12.00%	—	Bond yields rise sharply.	United States

World Interest Rates

market rates of January 30, 1980; bond yields as of January 25, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00 penalty rate 18.00	9.50*	2.00	6.25
Day-to-Day Money	13.50 Jan. 31	15.00	17.75	10.35	12.125	7.50	16.00	10.50*	0.80	8.25
Treasury Bills 91-day, Middle Rates	12.10	13.50	15.8125	14.40 120-day	n. a.	n. a.	14.261	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	13.10 finance paper	13.90 finance paper 15% tax w/h	15.25	10.40 Certified	n. a. Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.10	13.80 15% tax w/h	16.9375	12.75 Certified	not traded	9.40	n. a.	no market	3.25 not traded	no market
Government Bonds Long-term, new and old issues, average yield	11.82	12.50	13.60	11.01 20% tax w/h	11.67	8.19	14.05	9.50*	4.59	8.01
Industrial Bonds prime, long-term, new and old issues, average yield	13.00 Aa Industrials	12.90	14.53	12.88 20% tax w/h	12.91	8.19	14.35	10.41*	5.64	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.25	13.10	9.75	20.00	14.50*	4.25	6.50
Bank Time Deposits 3-month	13.25 Cert. of Dep.	13.85 Cert. of Dep.	17.5625	14.45	12.4375	8.65	10.75	11.00* large deposits	5.8125 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.1875	no market	17.6875	no market	12.75	8.375	no market	11.1875	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8608	2.2635	.0354	.2459	.5753	.001239	.5205	.6161	.004186
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.625 *P*	3.375 *D*	FLAT	1.625 *P*	6.00 *P*	8.125 *D*	3.00 *P*	8.75 *P*	5.50 *P*

Eurodollar Deposits

(London, interbank, bid)
January 31

7-day	15.50
1-month	13.9375
3-month	14.3125
6-month	14.3125

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .13
U.S.-Canada Treasury Bills	−1.41
U.S.-Canada Finance Co. Paper	−1.23
Eurodollars-U.K. Local Auth. Deposits	+ .44

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.125
Over 7 yrs.	12.875
DM Bonds	
7 yrs. and under	8.00
Over 7 yrs.	8.00

Gold Price

London
afternoon fixing

691.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Jan. 23; bond yields as of Jan. 18.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	13.3 (Dec.)	9.8 (Dec.)	17.2 (Dec.)	11.8 (Dec.)	5.4 (Dec.)	19.8 (Dec.)	5.2 (Dec.)	5.8 (Dec.)
Industrial production*	0.3 (Dec.)	2.3 (Nov.)	3.4 (Nov.)	2.3 (Nov.)	5.9 (Nov.)	6.7 (Nov.)	0.9 (Oct.)	9.9 (Nov.)
Trade balance† *(billions of local currency units)*	−$3.1 (Dec.)	C$5.3 (Nov.)	−£.07 (Dec.)	−FF.77 (Dec.)	DM.80 (Dec.)	−Lit1,480 (Dec.)	−SF.41 (Dec.)	−¥230 (Dec.)
Money supply (M_1)*	5.7 (Dec.)	2.4 (Dec.)	10.9 (Nov.)	11.3 (Oct.)	7.3 (Dec.)	22.2 (June)	1.1 (Oct.)	7.8 (Nov.)
Velocity of money (M_1)*	5.9 (Sept.)	5.2 (Sept.)	−0.2 (June)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	+1,349 (Nov.)	+34 (Nov.)	+249 (Nov.)	+661 (Oct.)	−3,445 (Nov.)	−44 (Nov.)	+562 (Nov.)	−3,120 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Link Between U.S. and Canadian Policy

The link between the U.S. and Canadian economies is widely acknowledged but broader than most observers realize. The uniquely close relationship of the U.S. and Canadian dollars in foreign-exchange markets is a well-known manifestation of the linkage. Less obvious, perhaps, is the convergence of economic policy that this currency relationship forces upon the two economies.

The essence of the U.S. and Canadian dollar relationship is the high degree of substitutability of the two currencies, which in turn stems from several factors: Both currencies are used interchangeably in Canada and along the northern tier of the United States; U.S. and Canadian monetary and political authorities function similarly; and the capital and product markets of both economies are well-integrated.

This relationship has led to the charge by some that, given the preeminence of the U.S. economy, Canadian economic policy is dictated in Washington. It is perhaps more accurate to say the relationship demands that both economies have similar long-run monetary and fiscal policies. Thus, it is difficult for Canadian authorities to pursue interest-rate and exchange-rate policies significantly different from those of the United States. Indeed, if Canadian policymakers decide to follow divergent long-term economic policies, evidence indicates that the cost of doing so is extremely high.

To see how the relationship reveals itself, it is useful to review briefly the interaction of interest rates, exchange rates, and money growth, which is well-documented in economic theory. Briefly, if the monetary authorities in a country boost interest rates unilaterally, money growth will be restricted and the forward-exchange premium on the country's currency will be raised as a result of arbitrage. (If the foreign-exchange market is convinced that the low money growth will hold, the currency will strengthen in the spot market.) By the same token, a change in *expectations* about money growth (and inflation) will tend to affect the exchange rate and interest rate. For example, if a shock—such as sharply higher oil prices—triggers expectations of a weaker currency and higher inflation, then the forward-exchange market would reflect this expectation. Subsequently, either interest rates or the spot exchange rate—depending upon whether either variable was fixed by official policy—would adjust to the shift in expectations through the opportunities presented by arbitrage.

The interaction of these market forces is heightened by the special relationship between the U.S. and Canadian currencies and by the integration of their capital markets. Although the relationship is not one of *perfect* substitutability—in which interest and inflation rates would have to be the same and the spot exchange rate fixed—the high degree of substitutability still demands that the monetary policies of the two countries converge. For example, if Canada were to pursue a more expansionary policy than the United States, the currency substitution phenomenon would mean that Americans would also borrow Canadian dollars. This would not affect the exchange market, however, since market participants (in the United States and Canada) would continue to accept Canadian dollars in lieu of U.S. dollars with the anticipation of an eventual change in Canadian policy to conform with that of the United States. Thus, the substitutability actually helps delay the exchange-rate effects of divergent policy. But if expectations suddenly change so that the market comes to believe that Canadian policy will *continue* to diverge, then the demand for Canadian dollars would fall and their exchange value would drop sharply.

The point can best be illustrated by the recent behavior of these market variables. Following the November 1978 U.S. actions to support the American dollar, the Canadian currency gained, not lost, ground against the newly strengthened U.S. dollar. This is because the markets *expected—and soon got*—a similar Canadian policy package. Indeed, no loss of Canadian dollar value was needed, as expectations buoyed the Canadian dollar until the response came.

A second illustration is perhaps more interesting. On October 6, 1979, the United States assembled another dollar-support package. The Canadian dollar's value exceeded US$0.85 at the time. For four days the rate held fairly steady. But then the market became concerned about a possible reluctance on the part of the Canadian authorities to match the U.S. interest rate moves. This triggered a sharp drop in the Canadian currency's value. It rebounded after the Canadian authorities introduced a similar policy formula, but the bounce-back took longer since some of the market's confidence in the Canadian authorities' responsiveness was eroded.

In sum, it appears that any effort on the part of the Canadian authorities to diverge permanently from an interest-rate policy followed by the United States will lead not to mild or gradual depreciation or appreciation, but rather to sharp movements in the Canadian currency's value. Brief divergences in interest-rate policy, however, are tolerated, and even accommodated, by the exchange market as the capital markets—owing to currency substitutability—absorb potential exchange-rate pressures. The market thus serves as a stern taskmaster, demanding, in the long run, that Canadian and U.S. policymakers follow similar paths, but forgiving short-run divergences.

D. Sykes Wilford

The Eurodollar—CD Difference

The links between the external Eurodollar market and the domestic U.S. money market are extremely close. But the persistence of a large interest-rate differential between Eurodollar deposits and domestic certificates of deposit (CDs) of similar maturities raises some perplexing questions: Why is arbitrage unable to eliminate the differential between these two closely linked markets? More specifically, why do some U.S. depositors choose CDs, shunning higher returns on Eurodollar deposits?

The answers to these questions require a look at both sides of the balance sheet of banks operating in both the U.S. money market and in the Eurodollar market. On the lending side, any loan made by a bank, whether booked in the Euromarket or domestically, must be funded. The economics of liability management suggests that banks seek the cheaper source of funds. In the Eurodollar market there are no reserve requirements or other government-imposed taxes. The interest rate, therefore, reflects the marginal cost of funding in this market. In the domestic money market, the marginal cost of funding is not fully reflected in the interest rate. Indeed, reserve requirements and deposit insurance raise the marginal cost of funding by about 1.08 times the interest rate on certificates of deposit. Banks are willing to offer a higher rate of return on Eurodollar deposits than for domestic CDs. And they will do so until the funding costs in the two markets are equalized.

On the other side of the market are the depositors, or the suppliers of bank liabilities. Depositors are generally assumed to adjust their portfolios until the risk-adjusted rates of return on the assets they hold are equal. Nevertheless, 90-day domestic CDs consistently offer rates of return that are 8%-9% (or currently between 100 and 125 basis points) less than 90-day Eurodollar deposits.

The willingness of some depositors to settle for less can be explained by several theories. One, depositors may be segmented into two groups—those inclined to invest in Eurodollar deposits and those interested only in domestic money-market investments. The latter group of domestic borrowers may lack the sophistication to tap investment opportunities in the external market, or may be constrained by internal policies or institutional reasons. A second theory is that a substantial group of investors perceives differences in risk between the two types of deposits. Since Eurodollar deposits are held in a foreign country, there is concern about capital controls, tax levies, or even political turmoil—risks that are virtually nonexistent in the domestic market. Finally, transactions costs in the Eurodollar market may be greater for U.S. deposit-holders than costs in the domestic CD market because of time-zone differentials and associated delivery risks.

For whatever reason, depositors are apparently willing to accept and sustain a difference in yields. And the persistence of a yield differential that seems to reflect almost precisely the cost of reserve requirements in the domestic market implies that the *banks* are the dominant arbitragers in the market. That is, depositors —who do not *all* arbitrage—might be willing to accept even higher yield differentials. Banks, however, in the process of equalizing funding costs, force the differential to correspond to their differing costs in the two markets.

Bluford H. Putnam

Eurocurrency Market

(billion $, end of period)

	IQ/79	IIQ/79	IIIQ/79	IVQ/79	1978	1979 (est.)	1980 (est.)
Total Market Size							
Gross Size (Claims)	883.9	946.5	1,025.0	1,100.0	892.1	1,100.0	1,350.0
Net Size (Claims)	550.0	585.0	625.0	670.0	535.0	670.0	820.0
Liabilities to Private Nonbanks	145.0	155.0	162.0	170.0	140.0	170.0	210.0
Claims on Foreign Nonbanks	285.0	295.0	307.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	273.5	297.0	324.3	335.0	259.9	335.0	400.0
Liabilities to Private Nonbank Foreigners	57.8	60.7	65.4	72.0	57.8	72.0	87.0
Total Claims on Foreigners	278.4	293.0	316.5	325.0	281.5	325.0	405.0
Claims on Foreign Public Borrowers	35.7	36.1	38.7	40.0	33.8	40.0	55.0
Claims on Foreign Private Nonbank Borrowers	103.5	107.7	113.1	120.0	104.3	120.0	140.0

Note: Gross and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

CHASE

International Finance

Vol. XV, No. 4
February 18, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

B 1900-1

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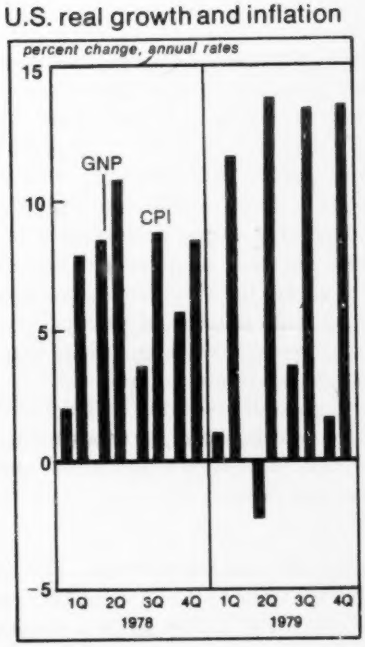
FEB 20 1980

U.S. Economy Resists Recession

It remains to be seen if the long-heralded U.S. recession is yet under way. The evidence is still quite contradictory. Two facts about the U.S. economy do, however, seem clear. First, if it is not declining, it certainly is not growing very fast. Second, the rate of price inflation in the United States remains extremely high by past standards.

There is no doubt about weakness in some important sectors of the U.S. economy. Construction of new housing has been hampered by financing difficulties associated with record-high interest rates. In recent months, new housing units have been started at annual rates 25% below the 2-million level of 1977 and 1978, and further declines are expected. Sales of new automobiles, while highly erratic on a monthly basis, have averaged sharply lower than the 11.2 million units of 1978. Sales of new trucks have fallen even further than auto sales. Some broader economic measures also show weakness. Industrial production, for example, peaked in March 1979, although the decline since then has been modest.

U.S. real growth and inflation



Total activity, however, refuses to decline. Real GNP dropped last spring, but then recovered to show a modest gain of about 1% between the fourth quarters of 1978 and 1979. Employment increased by two million over the year; the unemployment rate was stable until it moved up 0.3 percentage points, to 6.2%, in January. In the face of declines in real income, Americans managed to maintain their level of spending for products other than automobiles last year by reducing their rate of saving. The savings rate has already fallen to record lows for peacetime. Total activity was also bolstered by an increase in capital spending by business and by growth in exports.

Economic activity seems likely to follow a similar pattern in early 1980—up a little here, down a bit there, but not much change overall. Barring shocks such as last year's gasoline shortages, the near-term outlook apparently turns on consumer behavior. For the next several months, at least, consumer prices will continue to rise at rates at least as bad as the 1979 figure of 13.3%. The key question is how long consumer spending can hold up in the face of continued erosion in real income. No other major source of expansionary pressure is on the immediate horizon; the announced increase in military spending programs will have little effect on overall activity until well into 1981. With real consumer spending up again in January, it appears that consumers are not yet ready to pull in their horns. Consequently, the general economic decline may not yet have begun.

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The U.K. monetary outlook.

The U.K. Government has been pursuing a restrictive monetary policy with the understanding that once growth in loan demand moderated, interest rates would be reduced. But the British financial markets were shaken in early February by the announcement that despite record-high interest rates, bank lending was still increasing at a rapid pace. Accordingly, a drop in interest rates now appears less imminent, and most observers see little scope for any change until well after the new budget is introduced in late March. As a result, sterling assets remain attractive to overseas investors, and the pound has been gaining strength—climbing above \$2.30 and DM 4.00. The tight monetary policy, however, is also expected to dampen economic growth through 1980 and give the United Kingdom a negative growth rate for the year. This expectation is partly borne out by recent bank lending statistics. The figures reveal a declining proportion of consumer lending and a rising share of lending channeled to industry, indicating less buoyant consumer spending and firms' increased needs to finance unanticipated stockbuilding. As the slowdown gathers momentum, the scope for a cut in interest rates will be increased. Thus, the second half of this year could see a significant easing of credit conditions.

Swiss money policy continues restrictive, but with an eye on the franc.

Swiss monetary policy remains highly restrictive. The narrow money supply (M_1) recorded near-zero growth in the second half of 1979, evidence of the authorities' success in reducing domestic liquidity throughout the year. For 1980, a 4% target growth rate has been set for the monetary base. But since exchange-rate stability remains the key Swiss policy objective, the target may be viewed flexibly. In the short run, high U.S. and German interest rates will keep monetary policy on its present course. However, tight money will produce a lower level of domestic activity in the second half of this year and should help reduce inflation to between 3.5%-4%, as compared with the current rate of more than 5%. Thus, lower interest rates are likely to result around midyear. Since rates are also expected to decline abroad, the downward pressure on rates may be heightened by Swiss actions to prevent an appreciating franc.

Iceland hard put to combat inflation forcefully.

Iceland possesses abundent supplies of cheap geothermal energy, so that the increases in world energy prices have been favorable to the country's energy-intensive aluminum smelting operations and its new ferrosilicone plant. Nonetheless, the impending slowdown in world economic activity is expected to reduce GDP growth to only 1% in 1980 from 2.5% in 1979 and 4.2% in 1978. At the same time, Iceland's balance of payments is likely to shift into deficit after almost two years of surplus. Despite the reasonably strong performance of the real economy, inflation remains high. The rate has risen by about 45% in each of the last two years, and a similar advance is projected for 1980. Successive governments have tried to contain inflation, but the large number of political parties vying for the votes of 220,000 people tends to produce weak coalitions that are unable to implement effective anti-inflationary programs. In the wake of the election of December 1979, it has proven impossible even to form a coalition government. This suggests that the most any new government can do—once it emerges—is to adopt a restrictive monetary and fiscal stance and allow market forces to reduce the upward pressure on wages and prices.

Taiwan's external accounts weak; but foreign investment surges.

The Taiwanese balance-of-payments position deteriorated last year. The trade surplus is estimated to have fallen to \$1.3 billion from \$2.2 billion in 1978, with the current account shifting into a deficit of about \$50 million, after a surplus of \$1.7 billion in 1978. Heavy short-term capital outflows contributed to an overall payments deficit of some \$250 million. The worsened trade account was the result of a 42% rise in the cost of imports and an increase of only 27% in the value of exports. Oil imports alone totaled about \$2.2 billion in 1979, up 37% in cost and 11% in volume terms above 1978. Expenditures on invisibles also rose sharply. On the brighter side, foreign investment approvals in 1979 set a new record of $329 million, with applications coming from overseas Chinese ($147.4 million), the United States ($80.4 million), and Japan ($50.5 million). The outlook for 1980 calls for continued expansion in the overall payments deficit spurred by high oil prices and expectations of a weak export performance associated with a worldwide growth slowdown. By 1981, however, the external accounts should return to balance, and the longer-run prospects are favorable.

Barbados economy enjoying broad-based growth.

Economic growth in Barbados advanced briskly in 1979. Nominal GDP exceeded $500 million, boosting per capita income to nearly $2,000. A record year for tourism was behind much of the growth, with arrivals up 7% from 1978. Hotels on the island are currently registering occupancy rates of 90%, which has prompted plans to construct 2,000 new hotel rooms. This in turn has placed increasing demands on imported materials and skilled labor. Other sectors of the economy are also performing strongly. A large 125,000-ton sugar crop is anticipated in 1980, and with expectations of higher prices, export earnings should rise substantially this year. The industrial sector is also exhibiting strength, particularly assembly and manufacturing. Thus, the combined momentum of tourism, agriculture, and industry is expected to generate another year of substantial GDP growth in 1980. But price pressures are also building, and the island's inflation rate could very well exceed the 13% rate of 1979.

Saudi current-account surplus expanding sharply.

Saudi Arabia's current-account surplus is estimated to have soared to $16¾ billion in 1979 (on an accrual basis, after official transfers), in contrast with a surplus of about $2 billion in 1978. The sharp rise is attributable to markedly higher net oil export revenues and much slower import growth—which in turn reflects a slowdown in government spending in 1979. The Kingdom's net oil revenue jumped nearly 57% to about $56¼ billion in 1979, a result of the 14.8% increase in petroleum production—which averaged 9.53 million barrels per day—and a 37% rise in contract oil prices. Contract prices (weighted by type of crude exported) rose from an average $12.59 per barrel in 1978 to $17.21 last year. The 1980 Saudi current-account surplus will be sharply higher than in 1979. Even if oil export prices do not rise any further this year (from their current average price of $25.85 per barrel, up 50% from 1978); if 1979 oil output averages 9 million barrels per day; and if imports grow 25% in current dollars; the country's current-account surplus would still nearly double to $32¼ billion in 1980. If oil prices are lifted again this year and/or imports grow at a slower rate (e.g., 20%), the surplus could widen to the $34-$38 billion range.

Tin outlook clouded by international disputes.

After several unsuccessful attempts, the U.S. Congress has finally authorized the domestic sale of 35,000 tons of tin from a total excess of 168,000 tons in the U.S. Government's strategic stockpile. Up to 5,000 tons of this amount will represent the U.S. contribution to the now-depleted buffer stock under the International Tin Agreement (ITA). Domestic sales at a rate of up to 10,000 tons per year could begin some time in March. But there is still considerable doubt about the timing and extent of the sales because of the opposition of tin-producing members of the ITA, led by Bolivia, which has accused the United States of "economic aggression." In view of this uncertainty, and reports that user inventories are low, tin prices have risen to well above levels that would normally have triggered sales from the ITA buffer stock. Nevertheless, supply/demand conditions are currently in approximate balance, with a surplus expected to develop later this year as demand weakens. Prices are thus likely to fall once again, especially if the United States goes ahead with its domestic sales plan.

The New Aggregates and Monetary Policy

The Federal Reserve's recent release of its redefinitions of the monetary aggregates had little impact on most projections of the near-term course of monetary policy. There is, however, much skepticism over whether these new aggregates will significantly enhance the Fed's ability to conduct a more effective monetary policy.

In its release, the Fed announced the creation of five new monetary aggregates:

- M_{1A}, equal to old M_1 (currency plus demand deposits) less demand deposits held by foreign banks and official institutions;
- M_{1B}, equal to M_{1A} plus other "checkable" deposits at all depository institutions, including automatic transfer service (ATS) accounts, negotiable order of withdrawal (NOW) accounts, credit union share drafts, and demand deposits at mutual savings banks;
- *new* M_2, equal to M_{1B} plus savings and small-denomination time deposits at all depository institutions, money market mutual fund shares, overnight repurchase agreements (RPs) at commercial banks, and overnight Eurodollars held by nonbank U.S. residents at Caribbean branches of Federal Reserve member banks;
- *new* M_3, equal to new M_2 plus large-denomination (greater-than-$100,000) deposits at all depository institutions and term RPs at commercial banks and savings and loan associations;
- L, equal to new M_3 plus other liquid assets not included elsewhere, such as term Eurodollars held by nonbank U.S. residents, bankers' acceptances, commercial paper, Treasury bills and other liquid Treasury securities, and savings bonds.

The Fed noted that its action was "prompted by the many financial developments that have altered the meaning and reduced the significance of the old" monetary measures. An important question regarding the new aggregates is thus the extent to which their behavior is "more significant" than that of the old aggregates. This is not easily answered, since there is some controversy over the relevant criteria for a "significant" aggregate.

One criterion often suggested for selecting among alternative measures of monetary aggregates is the relative stability and predictability of the relationship between the demand for each aggregate and the ultimate target(s) of monetary policy, such as GNP. Indeed, one reason why many economists began to question the significance of the old aggregates is that the relationship among these aggregates, GNP, and interest rates has not been very stable during the

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979*		BALANCE O			
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Asia	**Bangladesh**	Despite drought conditions, rice production rose 7% in 1979.	June	+24%	8.9	$ 103	Dec.	386	+ 23%	2.9
	Burma	Japan will lend $100 million for industrialization projects.	Oct.	+81%	4.3	128	Dec.	194	+101%	7.8
	China, People's Republic	Moderate growth of 5%-6% expected to continue in 1980.	June	+40%	515.0	510	June	3,538	+ 11%	3.0
	Hong Kong	China business and Southeast Asia investor interest will maintain market buoyancy.	Dec.	+37%	16.6	3,320	n.a.	—	—	—
	India	Real GNP in current fiscal year (ending March) estimated to decline 3% or 4%.	Sept.	−18%	122.1	188	Sept.	7,655	+ 24%	11.2
	Indonesia	Oil production fell 5% to 1.55 million barrels per day in 1979.	June	+20%	61.6	413	Dec.	4,062	+ 55%	4.5
	Japan	Real growth in FY 1980 officially forecast to slow to 4.8% from 6.3% in FY 1979.	Oct.	+ 2%	1,078.2	9,310	Dec.	19,522	− 40%	2.1
	Korea	Inflationary pressure continues to build in wake of won devaluation.	Sept.	+24%	64.5	1,697	Oct.	3,073	+ 22%	3.7
	Malaysia	Business confidence apparently unaffected by expectation of U.S. recession.	Aug.	+58%	17.3	1,310	Oct.	3,963	+ 19%	6.6
	Pakistan	Record FY 1978/79 wheat crop boosting agricultural production growth to 6%.	Oct.	+58%	20.9	265	Dec.	213	− 48%	0.6
	Philippines	Government to launch ambitious industrial projects to modernize and diversify economy.	Dec.	+13%	29.1	612	Dec.	2,250	+ 28%	4.8
	Singapore	Year-old property market boom appears to be accelerating further.	Sept.	+47%	8.9	3,708	Sept.	5,694	+ 20%	4.2
	Sri Lanka	Government to receive $10.9 million from Asian Development Bank for rural credit project.	Sept.	+30%	3.1	206	Nov.	461	+ 22%	4.1
	Taiwan	Government increasing incentives for industrial R & D to boost manufacturing value added.	Oct.	+30%	27.6	1,623	Dec.	1,467	+ 4%	1.3
	Thailand	Border troubles and labor unrest undermining business confidence.	Sept.	+27%	26.0	565	Dec.	1,843	− 8%	3.4
Oceania	**Australia**	Business activity remains buoyant; industrial production rises rapidly.	Nov.	+38%	124.0	8,551	Dec.	1,424	− 31%	1.1
	New Zealand	Real GNP growth in fiscal 1980 will decline to 0.5% from 2% in FY 1979.	Oct.	+24%	15.4	4,812	Nov.	603	+ 24%	1.7
	Papua, New Guinea	A $94-million joint U.K. sugar project will begin this year.	Sept.	+44%	0.9**	513	Nov.	571	+ 29%	18.6

*Preliminary **1978

1970s, especially since mid-1974.

Empirical research by the Federal Reserve Board suggests that the demands for both M_{1A} and M_{1B} have exhibited about the same instability as that for old M_1 during the 1970s, with M_{1B} behaving somewhat more predictably. For the new broader aggregates, however, the same research suggests that the relationships among these aggregates, GNP, and interest rates have been more stable than such relationships using the old broader aggregates. It also appears that new M_2 has been associated with the most stable of such relationships. Moreover, in equations relating GNP growth to money growth, a fiscal variable, and a labor strike variable, new M_2 significantly outperforms all of the old and other new aggregates in terms of the proportion of GNP growth "explained".

Of course, these relationships can only be estimated on a historical basis, and may not hold in the future. As an example, consider the case of M_{1+}, or old M_1 plus savings deposits at commercial banks and other "checkable" deposits at banks and thrifts, introduced in 1978. According to a Fed economist, the demand for M_{1+} appeared to be a relatively stable function of GNP and interest rates until mid-1978. But the relationship fell apart from late-1978 on, and M_{1+} soon fell into oblivion.

A second key criterion for choosing among alternative aggregates is the extent to which the aggregate can be controlled by the Fed. For policy purposes, the significance of the relationship between some aggregate and the ultimate policy targets is limited if the Fed cannot control the aggregate's behavior.

The new redefinitions, however, are not designed to improve the Fed's control over the behavior of the aggregates, but rather to reflect changes in the nature of the public's financial assets. Nothing has been done to strengthen the far-from-perfect relationship between bank reserves and the monetary aggregates.

Furthermore, these monetary redefinitions attempt to deal with the *effect* of financial developments on the behavior of the old aggregates, and not with *causes* of these developments. Specifically, the major catalysts for these developments—deposit interest rate ceilings and punitive reserve requirements on certain categories of bank deposits—remain in effect. Consequently, there is significant potential for further financial innovation that may necessitate future redefinitions of the monetary aggregates.

Thus, while the new aggregates may in some ways be superior to the old aggregates, the old dual problems remain: determining growth rate targets for these aggregates that are consistent with some specific macroeconomic goals; and taking monetary policy actions that assure that these growth targets are attained.

Thomas A. Lawler

PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF, mil- dollars	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
		latest data	consumer prices	latest data	domestic credit	February 13, 1980			
27	Trade deficit of $1.4 billion projected for 1979/80.	Sept.	+17%	Sept.	+ 14%	—	.0675	Tight monetary policy in place to fight inflation.	Bangladesh
71	Oil exports in 1980 projected at one million barrels.	Oct.	+11%	n.a.	—	—	.1575	Relaxed monetary policy continues.	Burma
0	Import growth slowed in second-half 1979.	n.a	—	—	—	—	.7000	Restraint on domestic investment continues.	China, People's Republic
—	Trade deficit in 1980 will be offset by heavy foreign investment.	Oct.	+12%	Nov.	+ 26%	—	.2055	Credit boom continues despite high interest rates.	Hong Kong
0	Trade deficit of $2.5 billion forecast for FY 1980, owing to weak exports.	Oct.	+ 7%	Sept.	+ 19%	9.00%	.1290	Credit conditions restrictive.	India
0	Non-oil exports estimated at nearly $5 billion in 1979.	Oct.	+31%	June	+ 36%	—	.001640	Credit growth remains strong.	Indonesia
0	Oil bill could reach $60 billion in 1980.	Dec.	+ 8%	Oct.	+ 11%	6.25%	.004132	Ceilings on bank lending will continue in 1980.	Japan
8	Oil imports in 1980 estimated at $6 billion.	Dec.	+21%	Oct.	+ 37%	15.00%	.0020	High-interest-rate policy to be maintained.	Korea
0	Oil exports help sustain healthy payments position.	Nov.	+ 4%	Oct.	+ 3%	—	.4605	Government still opposes raising interest rates.	Malaysia
4	Export values jumped 30% in 1979.	Nov.	+ 9%	Sept.	+ 26%	10.00%	.1020	Large budget deficit boosts money supply growth to 15%.	Pakistan
8	High oil-import costs to offset gains in sugar, copra, and copper.	Oct.	+31%	Sept.	+ 24%	4.00%	.1365	Money supply tightened to conform to IMF guidelines.	Philippines
0	Demand for capital-goods imports expected to rise.	Nov.	+ 7%	Sept.	+ 20%	—	.4650	Interest rates climbing as inflation accelerates.	Singapore
9	Recent rise in tea prices will bolster export earnings.	Aug.	+ 6%	Sept.	+ 24%	10.00%	.0675	Tight monetary policy continues.	Sri Lanka
0	Current-account deficit of $1 billion forecast for 1980.	Nov.	+11%	Oct.	+ 18%	14.00%	.0290	Exchange-control liberalization may see temporary halt.	Taiwan
0	Poor sugar crop will hurt export performance this year.	Nov.	+14%	Aug.	+ 33%	12.50%	.0505	Usury law abolished to combat inflation.	Thailand
7	Exports to Japan in 1979 were 29% of total.	Sept.	+ 9%	Sept.	+ 12%	—	1.1070	Reserve Bank raises reserve deposit ratio to 6% from 5.5%.	Australia
6	High wool prices boosted export earnings 20% in 1979.	Sept.	+15%	Sept.	+ 15%	13.00%	.9840	Restrictive monetary policy continues.	New Zealand
3	Higher copper prices bolstered export growth in 1979.	Sept.	+ 5%	Nov.	+ 33%	—	1.47	Credit continues to expand rapidly.	Papua, New Guinea

World Interest Rates

market rates of February 13, 1980; bond yields as of February 8, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00* penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	14.25 Feb. 14	15.00	17.25	12.90	12.125	8.40	16.00*	11.125	0.75	8.25
Treasury Bills 91-day, Middle Rates	12.13	13.50	16.0625	14.40 120-day	n. a.	n. a.	13.712*	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	12.50 finance paper	13.95 finance paper 15% tax w/h	15.26	10.40 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.15	13.95 15% tax w/h	17.00	12.75 Certified	not traded	8.40	18.15*	no market	4.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	11.57	12.58	13.93	10.99 20% tax w/h	11.73	8.25	14.04*	9.92	4.48	8.11
Industrial Bonds prime, long-term, new and old issues, average yield	12.30 Aa Industrials	13.00	14.29	13.27 20% tax w/h	12.88	8.26	14.42*	10.75	5.46	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.50	13.10	9.75	20.00*	13.50	4.50	6.50
Bank Time Deposits 3-month	13.125 Cert. of Dep.	13.95 Cert. of Dep.	17.375	14.55	12.375	8.65	10.75*	12.00 large deposits	4.9375 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.3125	no market	17.4375	no market	12.375	8.5625	no market	12.00	5.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.80610	2.3075	.035475	.2458	.5760	.001242	.5227	.6186	.004132
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.125 *P*	3.625 *D*	.50 *D*	2.00 *P*	6.00 *P*	4.50 *D*	2.625 *P*	9.50 *P*	5.75 *P*

Eurodollar Deposits

(London, interbank, bid)
February 14

7-day	13.9375
1-month	14.1875
3-month	14.625
6-month	14.6875

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .08
U.S.-Canada Treasury Bills	−1.88
U.S.-Canada Finance Co. Paper	−2.37
Eurodollars-U.K. Local Auth. Deposits	+ .625

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.375
Over 7 yrs.	13.25
DM Bonds	
7 yrs. and under	8.25
Over 7 yrs.	8.25

Gold Price

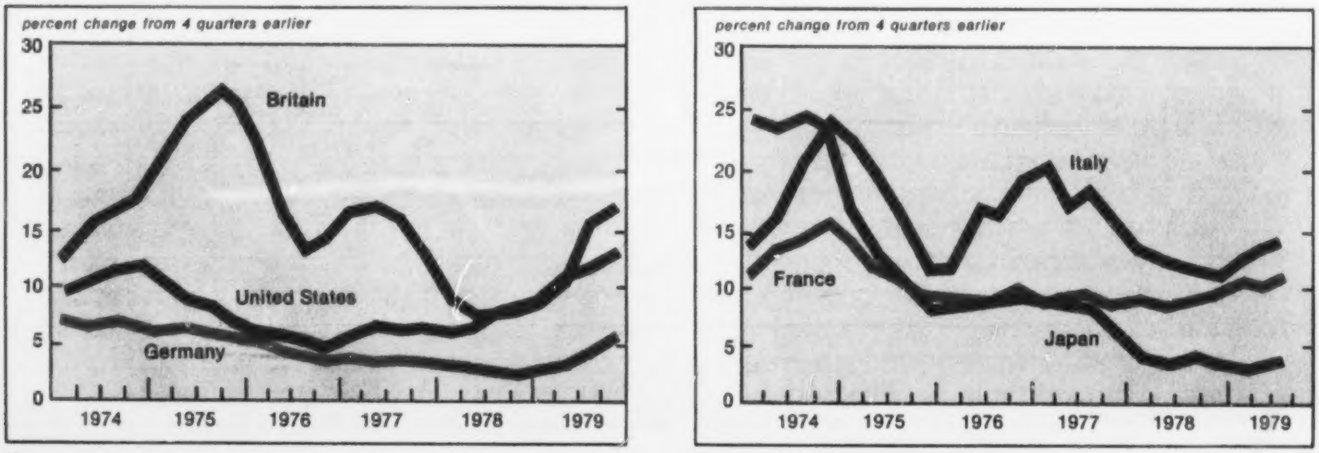
London
afternoon fixing

696.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Feb. 6; bond yields as of Feb. 1.

Consumer price trends in major industrial countries



Saudi Arabia Reappraising Priorities

In June of this year, Saudi Arabia's second five-year plan will come to a close. The period—which began with fiscal 1975/76—was marked by a high level of economic activity and inflation, with state outlays totaling approximately $175 billion in current prices, as against the $142 billion in constant dollars originally projected.

The major thrust of the second plan was primarily improvement of infrastructure, but emphasis was also given to expansion of hydrocarbon-based industries and development of the non-oil sector to reduce the country's dependence on petroleum. The plan has apparently achieved most of its objectives. The non-oil sector has expanded very rapidly in recent years. And although real growth in this sector did taper off from its 20% average annual rate during the earlier years of the plan to around 14% more recently, the non-oil sector's contribution to nominal GDP rose from 16% in fiscal 1973/74 to 40% last year. Construction advanced the fastest last year, accounting for 13% of GDP, while agriculture and non-oil manufacturing combined accounted for less than 2%. Thus, the country's petroleum sector continues to predominate. Saudi Arabia remains the world's largest exporter of crude oil, with current output averaging 9.5 million barrels per day. Petroleum earnings are responsible for 60%-70% of nominal GDP, 88%-90% of budget revenues, and nearly 100% of merchandise export earnings.

The Saudi economy grew an estimated 8%-9% in FY 1978/79 (ended in May 1979), spurred by increases in oil production and exports to compensate for reduced Iranian output and a sharp rise in state budget outlays. Real growth in the current fiscal year, however, is expected to fall to the 7% range. This slower growth projection is based on the expectation that oil export growth will weaken in FY 1979/80 in response to the anticipated softening in the world oil market. Furthermore, state budget expenditures this fiscal year are expected to approximate very closely the nominal 8½% increase officially targeted, as compared with the 32% nominal increase in fiscal 1978/79.

Actual state expenditures last fiscal year far exceeded the targeted $39 billion, reaching nearly $44 billion[1]—the first year in which actual expenditures exceeded budgeted amounts since world oil prices accelerated in 1973/74. The high level of expenditures, coupled with a 4% drop in oil revenues and higher imports, gave the Saudis something they were not accustomed to last fiscal year—a $4.3-billion budget deficit. In addition, the current-account balance (on an accrual basis) recorded a reduced surplus of $2 billion in calendar 1978, in contrast to the $23-billion surplus registered in 1974. (Preliminary official estimates indicate that the 1978 current account shifted into a *deficit* of some $57 million on a cash-flow basis.)

The deficit-induced "cash squeeze" forced the authorities to draw down state reserves by an officially reported $1 billion in October 1978 and by another $2 billion in February 1979. As a result, total foreign assets of the Saudi Arabian Monetary Authority (SAMA), the Saudi central bank, declined from $59 billion at the end of 1977 to $55¼ billion as of end-June 1979. In calendar 1979, however, higher oil export volume and prices, combined with slower import growth, raised the current-account surplus (on an accrual basis) to an estimated $16¾ billion; in 1980, the surplus could range anywhere between $32 and $38 billion. (See page 3.) The resulting additions to SAMA's foreign assets thus promise to enhance greatly the country's continued-strong financial posture.

The more restrained budgetary stance for the current fiscal year is partly a response to last year's drop in reserves, but also to fears of resurging inflationary pressure. The implicit non-oil GDP deflator—the most accurate measure of Saudi inflation—has in fact eased sharply from its peak of 52% in fiscal 1975/76 to an estimated 10%-11% in the current fiscal year. The moderation in inflation is a direct result of a broad range of anti-inflationary measures implemented by the authorities since 1977. These include—apart from this year's conservative budget—reducing the growth in the money supply from 54% in 1977 to less than 20% in 1979; acting to alleviate infrastructural bottlenecks; augmenting the supply of housing; revaluing the riyal vis-á-vis the U.S. dollar to curb rises in import costs; and substantially boosting subsidies for basic commodities.

Saudi Arabia's third five-year plan (1980/81-1984/85), to be published by June, will be a particularly revealing document. It will indicate how recent economic and political events have affected the country's longer-term development strategy; e.g., whether future development spending is curtailed or whether development priorities are substantially restructured. The probability is high that greater attention will be paid to improving social services, health delivery systems, education, and manpower training, with more resources allocated to development of non-urban areas and less to ambitious construction projects in major city centers. It is expected that priority will shift from general infrastructural expansion to development of the commodity-producing sectors, especially capital-intensive industry. Spending on national defense, however—which accounts for 33% of expenditures in the 1979/80 budget—will continue to enjoy high priority.

Sharif Ghalib

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[1] Excluding independent budgets of autonomous government agencies, which totaled nearly $9 billion.

The EEC Under Stress

The nine-member European Economic Community (EEC) is encountering rough going these days. The latest crises stem from the United Kingdom's objection to its substantial payments into the Community coffer and the Community's inability to reach a consensus as to the 1980 budget.

The British are upset about having to contribute an estimated £1 billion more to the EEC than they receive in receipts. The United Kingdom has the seventh lowest per capita GNP in the EEC but makes the largest per capita net payment of any member. This apparent inequity is primarily the result of the funding and disbursement practices of the EEC's Common Agricultural Policy (CAP), which penalizes agricultural-product importers while rewarding agricultural-product producers.

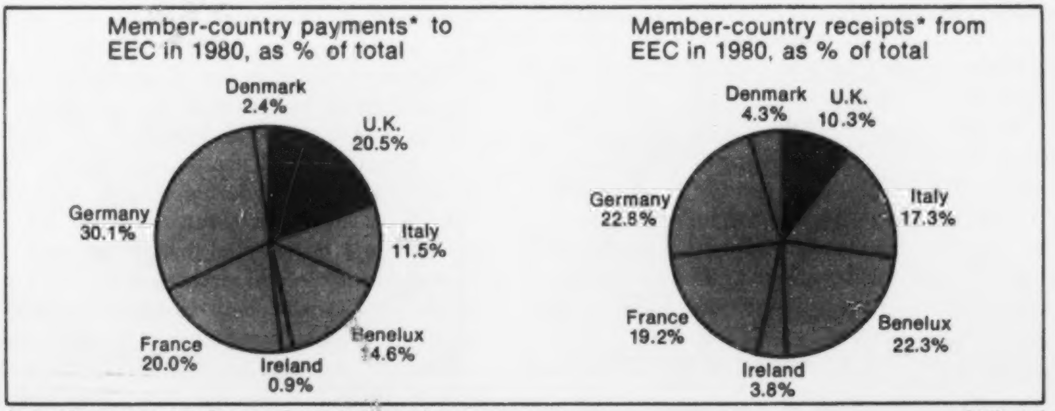
The CAP was designed to guarantee an adequate supply of agricultural commodities to member countries and maintain the income levels of small (and inefficient) farmers. It does this through price supports for EEC-produced agricultural products and by taxing agricultural imports from outside the EEC to maintain a parity with the subsidized EEC prices. The result has been a misallocation of resources, with agricultural supplies well in excess of demand. This in turn has produced large EEC stockpiles of such products as wine, milk, sugar, and butter, which are kept within relatively reasonable bounds only by dumping—i.e., selling at a price below the domestic price—in the world market. The cost of all of this is prohibitively high; indeed, CAP costs currently account for about 75% of total EEC expenditures.

The United Kingdom, which is highly dependent on agricultural imports, is no longer willing to foot the lion's share of the CAP bill without receiving compensating benefits. And since the Community's European Council opposes any actual reduction in U.K. payments, a compromise solution whereby increased EEC expenditures are channeled to the United Kingdom appears most likely. The most talked-about means include increased spending on transportation, infrastructure, and energy development—where U.K. needs are great; low-interest loans; modification of the "financial mechanism" allowing direct cash payments to the United Kingdom; and a tax on non-EEC oil imports to support higher U.K. oil prices. While prospects for a settlement—which would have reduced net U.K. payments by anywhere between £350-£700 million—had been improving, there are new reports of hardened bargaining positions by individual members that promises renewed Community squabbling.

The delay in ratification of the 1980 budget is also CAP-related. The newly elected European Parliament rejected the European Commission's budget proposal last December, with an excessive CAP allocation the main reason. The agricultural ministers of the agricultural-product-producing EEC members were apparently seeking still higher price supports, which would have boosted CAP allocations to a level that threatened to consume the entire Community budget. Accordingly, the agricultural-product-producers—notably France and Germany—must pressure their ministers and farmers to accept reduced price supports if the next budget proposal is to be approved at the Parliament's meeting in late February or March.

The European Parliament's rejection of the 1980 budget has great potential significance for the future of the EEC. The Parliament, which has budgetary authority over policies proposed by the EEC's legislative bodies, has demonstrated a new resolve to wield its (heretofore unexercised) power in the interest of achieving a better balance between agricultural, social, industrial, and energy expenditures. This task will be that much more challenging as the Community expands and its composition changes with the impending membership of Greece, Portugal, Spain, and, possibly, Turkey. The EEC will then have to cope with a more pronounced divergence of national interests and increased demands at the same time that its resources are growing more slowly.

Charles Burd



Source: Commission of the European Economic Community

**estimated*

CHASE

International Finance

Vol. XV, No. 5
March 3, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

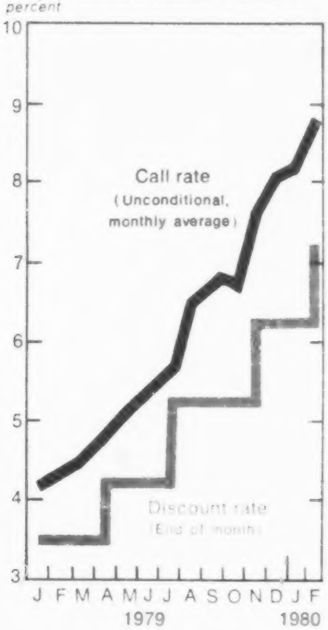
5/12/80 B 1900-1

Japanese Monetary Policy Tied to Yen Defense?

The timing of the recent hike in the Japanese discount rate underscores the increasing impact of exchange-market events on Japanese monetary policy. With the yen showing a renewed tendency to weaken, the authorities were unwilling to risk the possibility of another major attack on the yen arising from an abrupt widening in U.S.-Japanese interest rate differentials. Nonetheless, the Japanese decision has all the earmarks of a compromise. The Bank of Japan reportedly argued for a larger rate jump than that taken. The Ministry of International Trade and Industry, concerned for corporate profits and investment, apparently urged delay in rate adjustment. The Ministry of Finance seems to have been torn two ways, its concern for the impact of a weaker yen on domestic inflation pitted against its worry about the implication of higher debt-service costs. But having settled on the step taken, it will be difficult to make a further adjustment in the near future, for such an action would greatly complicate current parliamentary discussions on the FY 1980 budget.

Even so, it is anybody's guess as to how long the new discount rate will survive. Domestic inflation is accelerating rapidly, and the year-over-year increase in the Japanese consumer price index will approach 8% as the spring wage negotiations enter their crucial stage. The most recent trade data indicate that the long-expected turnaround in the balance of payments is still some time away, even though the growth of Japanese export volume has generally matched expectations. And despite the matching increase in U.S. and Japanese discount rates, the *difference* between short-term interest rates in U.S. and Japanese markets is now 50 basis points greater than a few weeks ago.

Japanese interest rates



Under these circumstances, continued pressure on the yen seems likely in the short run. If so, the Japanese authorities can be expected to mount a vigorous defense of the yen, activating the swap lines with the United States and withdrawing dollar deposits from Japanese banks overseas if necessary to acquire the currencies needed for large-scale market intervention. It seems questionable, however, that a yen-defense package would not include further increases in domestic interest rates if U.S. rates climb significantly from current levels. Whatever, the events of the next month or so should provide a good test of just how close the linkage between the foreign-exchange market and Japanese monetary policy has become.

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German real wage gains moderate.

The benchmark for Germany's 1980 wage round is the recent agreement with the metalworkers' union. Base wages are to rise 6.8%, and, in view of adjustments for the lower-paid, overall hourly wages will increase by about 7%. This is well below what many observers had expected, particularly because of last year's 5.4% rise in consumer prices, which exceeded the rise in hourly wage rates (but not that of actual earnings). The official year-on-year inflation forecast of 4.5%-5% for 1980 appears rather optimistic in light of anticipated movements in unit labor costs and import prices. Inflation is more likely to finish the year at 5.5%-6%, reducing real hourly wage gains to the 1%-1.5% range. With real GNP expected to grow between 1.5%-2%, or slightly below official forecasts, money supply growth in 1980 will likely fall in the upper end of the Bundesbank's 5%-8% target range, given unchanged velocity.

Italian economy set to slow from fast pace in 1979.

Italy's economy is now feeling the effects of over-expansionary economic policy and high oil prices. While real growth in 1979 is estimated at 4.5%—among the highest in Western Europe—the year-on-year inflation rate reached 22% in January, as against 13% in January 1979. The trade deficit widened sharply in the last months of 1979, giving Italy an estimated $5.7-billion deficit for the year, compared with the $425-million shortfall of 1978. The country's current-account surplus, a result of its traditional invisibles surplus, narrowed from $6.3 billion in 1978 to between $1-$1.5 billion in 1979. With world trade set to slow sharply and the average price of oil imports expected to rise at least as much in 1980 as in 1979, the current account is likely to shift into deficit this year. Such deterioration, combined with Italy's high inflation and rising world interest rates, could mean higher interest rates in the near future and an approximate halving of Italy's real growth rate in 1980.

Swedish economy retrenching.

In the face of an anticipated slowdown of most Western economies in 1980, the Swedish Government has begun to reign in its own economy. The authorities are motivated by the desire to avoid a repeat of the situation following the 1974 oil price run-up when strong Swedish growth matched by a worldwide recession led to a massive balance-of-payments deficit and high inflation. Public spending plans have been scaled back, and subsidies to weak industries—such as shipbuilding—are being reduced sharply. The Government had previously been expecting some 3% growth this year after 4.25% in 1979; an overall balance-of-payments deficit of 12 billion kronor, versus kr. 8.6 billion in 1979; and a rate of inflation of about 7%. But it now appears that these projections were overly optimistic. Substantial capital outflows forced the central bank to boost its discount rate to a record 10% in January. And in February, it was revealed that January consumer prices rose an alarming 3%—a figure that mocks the 7% official forecast for the year and threatens the delicate negotiations on a national wage agreement. Some private forecasters are now looking for 16% inflation in 1980, a rising balance-of-payments deficit, and growth of between 1.5%-2.25%.

Ecuador steps up oil exploration efforts.

Increased petroleum earnings have given Ecuador's foreign trade position a big boost. Although rising domestic consumption cut into export supplies, large oil price rises nearly doubled oil export revenues to $1 billion in 1979. As a result, the trade surplus widened to about $300 million from $217 million in 1978. With oil contributing about half of total export revenues, the Government is seeking to boost the country's 1.1 billion barrels of proven reserves. Exploration is being stepped up with the goal of achieving proven reserves of 2 billion barrels by 1984. The authorities are hoping that these efforts, which include incentives to attract international oil firms and deeper drilling and recovery techniques, should result in an average output of 230,000 barrels per day by 1982, as compared with 214,000 last year.

Higher oil prices and restrictive policies aid Venezuelan economy.

Restrictive demand-management policies, combined with much higher petroleum prices, improved Venezuela's economic situation substantially last year. Large cutbacks in central government expenditures lowered the budget deficit from 5.8% of GDP to about 1%, while monetary growth decelerated to 9.4% by fourth-quarter 1979 from 15.2% a year earlier. The resultant dampening of aggregate demand reduced pressure on imports. Import costs in 1979 registered no increase over 1978, which represents a decline from 28% of GDP to 24%. And since export earnings rose 50% as petroleum prices and volumes soared, the trade balance posted a $2.8-billion surplus. Thus, the current-account deficit is estimated to have shrunk from $5.3 billion in 1978 to about $1.5 billion last year. Official reserves, moreover, rose $1.3 billion to $7.7 billion by year-end. The conservative policies pursued, however, reduced growth from 4.8% in 1978 to some 3% in 1979, reflecting mostly gains in oil output. Inflation, on the other hand, continued to rise —reaching 20.5% by year-end—owing to the lifting of selected price controls, general wage increases, and interest rate adjustments.

Australia will see slower, but still satisfactory, growth in 1980.

Australian economic growth in the current fiscal year (ending June) is expected to slow somewhat from last fiscal year, but will still post a healthy increase. Although agricultural production will fail to match last year's 36% increase, continued strength in industrial production and investment—particularly in mining—are buoying the economy. Consumer spending, which accounts for 60% of GDP, is also exhibiting strength, spurred by delayed expenditures stemming from the sharp rise in farm incomes last year; it is estimated to rise about 2.5% in real terms, roughly the same as last fiscal year. Exports are performing extremely well, paced by increased demand for farm products and a surge in mineral exports. Exports rose 35% to nearly $10 billion in the first half of the fiscal year and are likely to sustain a strong, albeit slower, pace in the second half. The recent adoption of a tight monetary policy is expected to dampen growth during the second half, contributing to the slower real GDP growth rate of 3.5% anticipated for this fiscal year, as against 4.7% last year.

Jordan's economy on a strong growth uptrend.

Jordan's economy posted a 7% real growth rate in 1979, led by an 18% increase in industrial production and financed by nearly $1 billion in grants from other Arab governments. An even stronger performance is expected this year. Unusually plentiful winter rains have softened the impact of a fifth successive year of drought; a major new oil refinery is nearing completion; and phosphate production is set to expand rapidly again. Inflationary pressures in the domestic economy are building, however, fed by fuel price rises and the continued growth in domestic liquidity stemming from heavy remittances from workers abroad. No balance-of-payments problems are anticipated in 1980, despite a $100-million hike in the oil bill, because of the projected inflow of $1.6 billion in aid grants and remittances. And the level of foreign reserves remains exceptionally high, at more than $1.5 billion, sufficient to cover nearly 10 months of imports.

Rice prices to hold firm during 1980.

World rice production for the 1979/80 marketing season is estimated at 372 million metric tons, down 3½% from the record 1978/79 crop. The U.S. crop, which generally supplies about a quarter of total world exports, is expected to exceed last year's record output because of improved per-acre yields. But India, the free world's largest producer of rice, will experience a severe shortfall, owing to the worst drought in 40 years. And supplies available for export from Thailand will be down as a result of increased domestic consumption triggered by the influx of refugees from Cambodia. Currently excessive world stocks should be drawn down by more than three million tons over the course of 1980, much of this occurring in India. World rice prices, which have risen sharply in recent months, are therefore expected to remain firm throughout much of 1980.

New Pressures on Borrowing

The growth in both business loans at banks and nonfinancial commercial paper has accelerated significantly since mid-December. Moreover, there are no indications that this rapid growth in short-term business credit—which reversed the slowdown that had occurred after the Federal Reserve's October 6 policy move—will abate soon. Indeed, many analysts feel that the deteriorated conditions in the bond market, as well as the fear that credit availability may soon be curtailed, may be leading to an acceleration in short-term business borrowing.

From mid-October to mid-December, business loan growth at banks decelerated significantly, as did the growth in commercial paper. This slowdown, however, proved to be temporary. From mid-December to mid-February, business loans at large banks grew at an annual rate of almost 30%, while the volume of nonfinancial commercial paper outstanding increased at an annual rate of over 150%.

The combination of continued economic strength and accelerating inflation is one obvious reason for the resurgence in credit growth. Another source of both recent and near-term future strength in short-term credit demands, however, is the shifting of corporate borrowing from the bond market to banks and the commercial paper market. Corporate bond prices have exhibited unprecedented declines and volatility since January, and trading has been very thin. In such an environment, a number of corporations have had to postpone long-term bond offerings. Since corporations may be either unable or unwilling to alter significantly their near-term expenditure plans, however, they are likely to be looking to banks and commercial paper for their financing needs.

Recent indications that some kinds of more restrictive credit measures are being considered have heightened fears of curtailed credit availability. Under the Credit Control Act of 1969, the President may authorize the Federal Reserve to regulate any or all extensions of credit. Obviously, there are numerous forms that such regulation could take. Business firms as well as consumers could be covered. And as this issue goes to press, an announcement is distinctly possible.

A new credit program (probably coupled with other measures, although not broad controls on wages and prices) would not likely be designed to produce severe liquidity strains in the economy. Instead, it probably would be geared more toward influencing more cautious spending plans in coming months. As such, the near-term effects on inflation would be modest at best. And in fact, with underlying credit needs reasonably high in coming months, new credit measures pose a risk of aggravating current economic problems. A strong surge of new anticipatory borrowing would produce higher rates of interest and inflation and also prospects for serious financial dislocations.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE			
		3 months ending	change from year earlier	in billions of dollars	per capita	latest date	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	Prospects are for 3% real GDP growth in 1980, with some downtrend in inflation.	Nov.	0	102.0	$3,825	Oct.	9,175	+ 78%	27.2
Barbados	Record tourist arrivals and new industrial investments spur economic growth.	Aug.	+ 43%	0.5	2,000	Dec.	67	+ 12%	2.1
Bolivia	Economic austerity program being implemented in connection with IMF stand-by loan.	Sept.	+ 27%	4.7	930	Dec.	174	+ 2%	2.6
Brazil	Monetary and fiscal policy restrictive in effort to stem inflationary pressure.	Nov.	+ 18%	209.1	1,760	Sept.	9,260	− 7%	5.8
Chile	Fiscal policy tightened in effort to reduce 39% inflation rate.	Oct.	+ 75%	19.0	1,710	Dec.	1,938	+ 78%	4.8
Colombia	Government investment in energy, transport, and communication should sustain 6.5% growth in '80.	Dec.	+ 19%	28.7	1,100	Dec.	3,844	+ 63%	13.9
Ecuador	New five-year plan being drawn up projects 6.5% annual growth, stressing oil and agriculture.	June	+ 33%	8.7	1,070	Dec.	767	+ 15%	4.8
El Salvador	Mounting political tensions posing serious obstacle to business; GDP growth fell to 3.5% in 1979.	June	+ 48%	3.4	760	Dec.	140	− 48%	1.6
Guatemala	Authorities aim to curb 14% inflation via tighter price controls and higher agricultural output.	Dec.	+ 16%	7.2	1,060	Dec.	696	− 6%	5.9
Honduras	Public spending on hydroelectricity, forestry, and infrastructure continues heavy.	June	− 3%	1.9	540	Dec.	209	+ 13%	3.8
Mexico	Business activity brisk; strong increases in oil production, manufacturing, and construction.	Nov.	+ 53%	118.0	1,700	Sept.	1,887	+ 11%	2.0
Nicaragua	Emergency reconstruction plan emphasizes agriculture; $40 million from abroad available for industry.	May	+ 10%	1.7	660	Nov.	86	+ 42%	2.0
Panama	Economic activity approximating 4% real growth, paced by uptrend in construction.	Sept.	+ 15%	2.7	1,420	Nov.	111	+ 13%	4.4
Paraguay	Economic growth reached 9.5% in 1979, but inflationary pressures intensified.	Sept.	− 2%	3.7	1,225	Dec.	609	+ 36%	14.6
Peru	Government grants tax incentives and ups minimum salary 20% to boost domestic purchasing power.	Sept.	+107%	12.1	700	Dec.	1,520	+290%	12.9
Puerto Rico	Slowdown in construction and some drop in employment reflect recent softening in economy.	Nov.	+ 17%	10.2	2,925	Nov.	5,000*	+ 18%	9.2
Trinidad & Tobago	Increases in sugar and oil export earnings help sustain healthy business climate.	July	+ 21%	3.8	3,465	Dec.	2,138	+ 19%	14.2
Venezuela	Demand-management policies of 1979 likely to ease in view of high oil prices and social tension.	Dec.	+ 50%	46.1	3,386	Dec.	7,284	+ 21%	7.4

*Commercial bank deposits

A Spending Spree This Spring?

Retailers will not be the only ones anxiously anticipating consumer behavior this spring. Up to now, consumers have demonstrated a willingness and ability to maintain spending in the face of rising prices and declining real incomes. So in view of the alarming rise in January prices, economists and government policymakers will be nervously watching for signs that the spending spree has run its course, in hopes that this will contribute to an easing of inflationary pressures.

The report that consumer prices in January rose at an annual rate of 18% caused anxiety on the inflation front, particularly in light of the news that producer prices in the same month surged at a rate of 21%. Both figures represent sharp accelerations over 1979 rates. In addition, retail sales in January were surprisingly strong after a better-than-expected Christmas season, indicating that consumer spirits are still buoyant. Most forecasters now expect the long-predicted recession that was to have provided some relief from soaring prices to be pushed further into the future.

Although real incomes have declined almost 1% over the past six months, consumers have not reduced their spending pace. Such behavior is not irrational. The high spending levels have been induced largely by expectations that inflation is not likely to ease in the near future. Consumption has also been bolstered by cheap and easy borrowing and by increases in the wealth of many homeowners who have cashed in on inflationary spurts in home prices. At the same time, ceilings on passbook interest rates and the tax treatment of savings have made traditional forms of saving unattractive.

Consumers are probably correct in their expectations that high and volatile inflation rates will continue —at least in the near term. Mortgage interest rate hikes and price increases by foreign oil producers leave little room for optimism that prices for shelter and energy will moderate before mid-year. And the January CPI figures indicate that the acceleration of inflation is broader based. Prices for services and non-food commodities over the past three months have risen at an annual rate of 11%, compared with an 8½% rate of increase in the three months prior. But a continued worsening of inflation will depend largely on both consumers' ability and willingness to sustain their strong buying pace.

There are signs, however, that consumers' *ability* to maintain spending is tapering off. Consumer instalment credit growth has slowed; and high mortgage interest rates have dampened both housing demand and homeowners' ability to tap increased equities in their homes. In addition, continued declines in real personal income are expected.

Consumers' *willingness* to continue spending will be influenced by government policy. If consumers sense that the Government's resolve to "do something about inflation" will finally bring on recession, they are likely to curb their spending. But they will require some convincing signals.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
						February 27, 1980			
e of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit			current monetary conditions	
0	Slower devaluation-rate policy continues.	Jan.	+130%	Oct.	+188%	18.00%	.00064	Interest rates decline.	Argentina
9	Sugar export earnings rise strongly.	Nov.	+ 17%	Oct.	+ 16%	—	.5200	Credit growth moderate.	Barbados
20	Devaluation and stabilization measures should improve balance of payments.	Sept.	+ 12%	Sept.	+ 28%	—	.0520	Monetary policy restrictive.	Bolivia
0	Pre-fixed 40% devaluation announced for 1980.	Jan.	+ 82%	Aug.	+ 52%	33.00%	.0240	Cruzeiro availability very limited.	Brazil
79	Higher copper prices enhance trade performance.	Dec.	+ 39%	Aug.	+ 48%	—	.0275	International reserves continue to rise.	Chile
0	International reserves up a hefty $1.6 billion in 1979.	Oct.	+ 27%	Dec.	+ 15%	20.00%	.0275	Tight credit policy to offset rapid reserve growth.	Colombia
0	Trade surplus reached record level in 1979.	Oct.	+ 9%	Aug.	+ 33%	8.00%	.0400	Commercial loans up 24% as of end-year.	Ecuador
0	Exports hurt by agricultural output declines; foreign investment down.	Aug.	+ 7%	Nov.	+ 18%	—	.4025	Local capital is scarce.	El Salvador
0	High coffee prices and nickel export volume raised export receipts 16% in '79.	Oct.	+ 14%	Oct.	+ 28%	—	Par	Tight credit policy prevails.	Guatemala
0	Trade deficit in 1979 widened to about $240 million.	Sept.	+ 9%	Sept.	+ 22%	4.00%	.5010	Reserve requirement raised.	Honduras
6	Oil export rate reaches 1 million barrels per day.	Nov.	+ 19%	Oct.	+ 29%	4.50%	.0440	Long-term peso interest rates increased.	Mexico
7	Export earnings expected to fall slightly, owing to some missed plantings.	Dec.	+ 30%	Aug.	+ 56%	—	n.a.	Funds in short supply.	Nicaragua
2	Canal service receipts show strong increase.	Sept.	+ 9%	Sept.	+ 11%		Par	Credit growth rises moderately.	Panama
0	Large increase in soybean-product exports.	Dec.	+ 35%	June	+ 20%	—	.0080	Domestic loan volume up sharply.	Paraguay
2	Tariffs cut further to reduce inflation and spur domestic output efficiency.	Aug.	+ 65%	Aug.	+ 33%	29.50%	.0043	Net foreign assets continue to rise.	Peru
0	Tourism activity brisk.	Dec.	+ 10%	Nov.	+ 9%	—	Par	Interest rates rising.	Puerto Rico
0	Large increase in exports to Europe.	Nov.	+ 18%	Sept.	+ 29%	6.00%	.4100	Loans to manufacturing sector up substantially.	Trinidad & Tobago
0	Oil export earnings up 52% in 1979.	Dec.	+ 20%	Oct.	+ 13%	8.50%	.2335	Foreign reserves rising rapidly.	Venezuela

World Interest Rates

market rates of February 27, 1980; bond yields as of February 22, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	14.00	17.00	12.00	9.50	7.00*	15.00 penalty rate 18.00	9.50	3.00	7.25
Day-to-Day Money	14.75 Feb. 28	12.50	17.25	8.75	12.375	8.20	16.625	10.50	1.00**	9.5625
Treasury Bills 91-day, Middle Rates	13.80	13.50	16.0625	14.75 120-day	n. a.	n. a.	14.875 90-days	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	13.50 finance paper	13.85 finance paper 15% tax w/h	15.43	10.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.00	13.85 15% tax w/h	17.375	12.50 Certified	not traded	8.40	18.15	no market	4.00** not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.55	13.40	14.31	10.87 20% tax w/h	13.10	8.66	14.12	10.53	4.49**	8.34**
Industrial Bonds prime, long-term, new and old issues, average yield	13.35 Aa Industrials	13.95	14.50	13.08 20% tax w/h	13.66	8.48	14.49	11.68	5.39**	6.95**
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	15.00	18.00	15.50	13.60	9.75	20.00	13.50	4.50**	7.50
Bank Time Deposits 3-month	14.75 Cert. of Dep.	13.85 Cert. of Dep.	17.75	14.95	13.25	8.95	10.75	12.50 large deposits	5.375** residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	16.375	no market	18.125	no market	15.00	9.75	no market	13.00	6.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8714	2.2840	.03496	.2424	.5681	.001225	.5154	.5999	.004028
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.25 *P*	1.75 *D*	1.50 *P*	2.125 *P*	6.75 *P*	3.00 *D*	3.75 *P*	11.00 *P*	6.25 *P*

Eurodollar Deposits

(London, interbank, bid)
February 28

7-day	14.5625
1-month	15.625
3-month	16.6875
6-month	15.8125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .29
U.S.-Canada Treasury Bills	−2.33
U.S.-Canada Finance Co. Paper	−3.41
Eurodollars-U.K. Local Auth. Deposits	+ .88

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.25
Over 7 yrs.	15.50
DM Bonds	
7 yrs. and under	9.50
Over 7 yrs.	9.75

Gold Price

London
afternoon fixing

636.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Effective Feb. 29. ** Market rates as of Feb. 20; bond yields as of Feb. 15.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	13.9 (Jan.)	9.5 (Jan.)	18.4 (Jan.)	12.9 (Jan.)	5.0 (Jan.)	19.8 (Dec.)	5.1 (Jan.)	6.2 (Jan.)
Industrial production*	0.8 (Jan.)	2.3 (Nov.)	2.5 (Dec.)	3.8 (Dec.)	6.7 (Dec.)	8.2 (Dec.)	0.9 (Oct.)	8.4 (Dec.)
Trade balance† *(billions of local currency units)*	−4.76 (Jan.)	C$.727 (Dec.)	−£.35 (Jan.)	−FF4.63 (Jan.)	DM.80 (Dec.)	−Lit1,720 (Dec.)	−SF.92 (Jan.)	−¥281 (Jan.)
Money supply (M_1)*	8.0 (Jan.)	7.6 (Jan.)	10.9 (Nov.)	10.9 (Nov.)	9.3 (Nov.)	24.6 (Oct.)	−2.4 (Nov.)	7.9 (Dec.)
Velocity of money (M_1)*	5.9 (Sept.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	−232 (Dec.)	−85 (Dec.)	+499 (Dec.)	+960 (Dec.)	+3,285 (Dec.)	−116 (Dec.)	+2,500 (Dec.)	+164 (Dec.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Singapore's New Development Strategy

The small island state of Singapore is today the second richest nation in Asia, with a per capita GNP of $3,700. The country, whose inhabitants are 75% Chinese, possesses a solid economic base in manufacturing and services, a tribute to its sound economic management and disciplined labor force.

The economy reached its "takeoff" stage soon after Singapore attained its independence in 1965. The country's economic base was broadened through policies aimed at building up export-oriented industries with emphasis on labor intensity. Singapore financed the subsequent development with heavy reliance on foreign capital and technology, necessitated by its smallness and limited domestic saving capacity. Between 1968 and 1978, real GDP grew an average 10% per annum. Real growth last year was 8.5%, and the Government is planning on an average annual growth rate of 8% through the 1980s.

While Singapore is determined to sustain its rapid growth pace, the nature and course of its growth will be altered in the coming years. The authorities are concerned about the fast growth in the labor force—particularly the foreign component—over the past few years. Of the 7% average annual growth achieved between 1974 and 1978, productivity growth accounted for only 3%, while labor force growth made up 4%—2.5% of which came from abroad.

Singapore's labor-intensive development course was motivated by the Government's desire to redress serious unemployment problems in the economy. And the results were impressive; Singapore's rate of unemployment declined steadily from 7.3% in 1968 to 3.5% last year, at the same time that the labor force grew about 4%-4.5% per annum. Indeed, the country has now achieved full employment, and since Singapore does not wish to support a large population, it is seeking to raise productivity by shifting from labor-intensive to more capital- and technology-intensive industrial development. Accordingly, the Government unveiled a development strategy last year aimed at arresting the increasing utilization of migrant labor and transforming the country's labor-intensive industrial structure. The three-pronged strategy consists of:

1. a high-wage policy—which has boosted the national wage bill by 20%—to encourage employers to upgrade their operations and reduce their demand for unskilled labor;
2. expansion of technical and engineering manpower to meet the expected needs of high-technology, skill-intensive industries; and
3. incentives to attract foreign investment embodying capital and technology.

While the strategy is basically sound, it carries with it certain risks or potential problems. First, the high-wage policy runs the risk of boosting unemployment and the rate of inflation—which climbed to about 8% in 1979. This risk is minimized, however, by the relatively small impact of the higher wages on manufacturers' total costs, and the moderate, and possibly only short-run, impact on the country's inflation rate. The Government has nonetheless taken steps to smooth the adjustment process; these include accelerated depreciation allowances, and government assistance to firms for retraining workers and upgrading technology. A key concern is whether there will be a continuous flow of highly skilled workers to sustain the high-wage policy over the long run.

A second risk is that the manpower training programs will fail to emphasize the appropriate skills. Specifically, Singapore's quality education system has historically stressed industrial training. But the country's manufacturing sector is not expected to expand much beyond its present relative size, while the service sector is likely to grow in importance. Thus, manpower training programs must be reoriented and broadened—and respond to changes in labor needs over time.

The third risk or potential problem concerns the availability of capital. The new plan is counting on productivity growth to contribute at least 6% to the targeted 8% average annual growth in the 1980s. This will necessitate much higher capital/labor ratios in production, which in turn means that Singapore will have to generate substantially higher saving levels, both foreign and domestic. And although Singapore has attracted considerable foreign capital—mostly in the form of foreign direct investment rather than loans—it will face stiff competition from other Asian countries, such as Hong Kong and Taiwan, for a limited pool of foreign investment funds in the 1980s. Thus, increased domestic saving will be needed, particularly for use in the private sector where foreign capital has traditionally predominated. But the domestic financial sector is still relatively unsophisticated, and Singapore will have to introduce new mechanisms for raising and sustaining the necessary domestic savings. Even so, Singapore may have to depart from its tradition of minimal reliance on external debt.

One final risk is that the authorities will make inappropriate choices of technology or industry. While Singapore's managers have proven to be skilled decision-makers, their choices in this instance are especially difficult, and must be based on long-term considerations, both internal and external. Internally, the choices must be cognizant of the structural evolution of the economy, while externally, they must minimize the economy's competitiveness with its neighbors and maximize its complementarity.

Raymond Ch'ien
Chase Hong Kong

Holland Follows the Rest of Europe

The economy of the Netherlands is small and open, with its most important structural characteristics its trade dependence and large reserves of natural gas. Despite these features, which subject the Dutch economy to the vicissitudes of its external sector and the international economy, the country's growth has been stable, ranging between 2%-3% annually between 1977 and 1979, with an inflation rate for the same period averaging 5.1%, among the lowest in Europe.

Exports and imports each account for about half of Holland's $131-billion GNP. This high degree of trade dependence implies that the authorities have only a limited degree of control over aggregate demand. Furthermore, the "tradable" component of Dutch output (exportables and importables) is even larger than the portion actually traded. This degree of openness means that the Dutch price level is largely determined on world markets through international goods arbitrage. The price level in guilder terms can therefore be changed significantly only if the exchange rate changes. But this option is circumscribed by Holland's membership in the European Monetary System (EMS). Membership in the EMS also restricts the authorities' freedom to target a rate of monetary expansion.

The Netherlands' reserves of natural gas are a big influence on the country's external accounts. Proven reserves are estimated at about 2,227 billion cubic meters, and production and export figures since 1974 are as follows:

	1974	1975	1976	1977	1978	1979*	1980**
Production *(billion cubic mtrs.)*	83.7	90.9	97.3	94.8	90.2	100.0	n. a.
Exports *(billion cubic mtrs.)*	40.1	41.6	43.4	50.0	45.0	50.5	50.5

*estimate **forecast

Both gas production and export volume are expected to decline between 1980 and 1990, to some 66 and 28 billion cubic meters, respectively. This assumes, however, that no new discoveries are made and that potential reserves are discounted; if these assumptions prove incorrect, production and export levels could rise sharply over the next decade.

The Dutch economy performed unspectacularly in 1979. Real growth was an estimated 2%, and despite a sharp increase in natural gas output, industrial production registered no growth. The inflation rate was held to some 4.7%, despite a sharp rise in the price of of raw materials.

The volume trade balance was strong during the first three quarters of 1979—export volume was up 8.7% as against an import volume increase of only 6.5%. But an unfavorable shift in the terms of trade widened the trade deficit. The Dutch Central Planning Bureau estimates the 1979 current-account deficit at 1.5 billion guilders, compared with a 2-billion guilder gap in 1978.

The 1979 deficit stems in large part from Holland's energy balance. The country is a net exporter of natural gas and a net importer of petroleum products. Movements in the natural gas price tend to follow those of the oil price, but with a lag of six to nine months. Thus, in 1979, the average price of oil rose by over 50% while the average price of gas rose only 6%. This resulted in an estimated 1979 energy deficit of 2.5 billion guilders; thus, Holland had a non-energy current-account *surplus* of about 1 billion guilders.

The current year promises not much improvement in the Dutch economic performance. On the external front, the growth in the volume of world trade, weighted by Dutch export shares, is expected to decline sharply from 7% in 1979 to 2% this year. High inflation is expected to persist in the economies of Holland's trading partners, and the average per-barrel cost of oil will rise to $32, 62% higher than the 1979 average. The Central Planning Bureau is forecasting a current-account deficit of some 2.5 billion guilders, and some private forecasters are suggesting an even larger shortfall.

On the domestic front, the Government has not succeeded in reducing the public-sector deficit to 4%-4.5% of national income as it had proposed to do. With the sluggishness of the domestic economy, the public-sector deficit is now expected to be 5.5% of national income in 1980, roughly unchanged from last year's 5.7%. Wages are expected to rise by some 1.5%-2% in real terms when the current wage freeze expires, and higher costs already in place at the wholesale level point to retail price inflation of 6%-7%. Despite this, corporate profit margins are expected to be squeezed. On balance, real growth in 1980 is forecast to decline to about 1%, with the weakest points, capital investment and export volume.

Over the longer run, Holland is faced with several problems. Increasing the price-competitiveness of Dutch exports with a devaluation is difficult because of wage indexation, which would prevent any *real* reduction in the guilder's exchange value. Thus, in order to make exports more competitive, unit labor costs must rise less quickly in Holland than in its major trading partners.

Holland also faces the prospect of ultimately becoming an increasing net importer of energy. Thus, it will eventually have to reduce domestic absorption relative to output, which would mean that living standards would grow less quickly than output. This problem, however, is shared with several other European countries, and Holland's reserves of natural gas give it the opportunity for a slower rate of adjustment.

George de Nemeskeri-Kiss, Chase London

CHASE

International Finance

Vol. XV, No. 6
March 17, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

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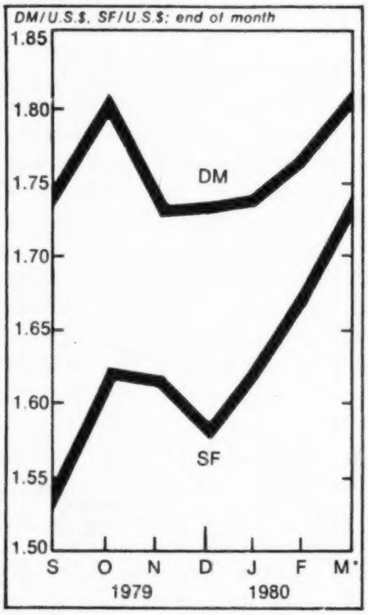
MAR 21 1980

Behind the German and Swiss Monetary Tightening

The recent rises in German and Swiss discount and Lombard rates were motivated by foreign-exchange considerations rather than domestic conditions. They were clearly meant to bolster the German mark and Swiss franc against a dollar much strengthened by higher U.S. interest rates.

Monetary growth in Germany is continuing well within its target range, and money market rates were already 300 basis points above the inflation rate prior to the latest rate hikes. Moreover, initial wage settlements of about 7% were moderate, and an economic slowdown is widely forecast for the second half of 1980. There was, therefore, no apparent domestic incentive for further German monetary tightening. This fact was acknowledged by the Bundesbank in its decision to raise commercial bank rediscount quotas by DM 3 billion and abolish the Lombard quota at the same time that it boosted rates.

The exchange values of the mark and Swiss franc



*as of March 11

In the open European economies, both the local currency oil-import bill and the price level are strongly affected by the exchange rate. In Germany, every 1% decline in the mark against the dollar raises the oil-import bill by about DM 600 million. While the inflationary impact is harder to quantify, a 1% decline in the mark could ultimately raise the German price level by as much as 0.5%. A substantial weakening of the mark could therefore trigger an uncomfortable surge in German inflation. The result would be either an erosion in real wage gains—which would spur higher wage demands in the longer run—or higher wage settlements from the current negotiations still proceeding.

Over the past two years, the German and Swiss authorities were able to avoid this dilemma. They did so partly by influencing exchange-rate expectations by means other than interest-rate policy. Now, however, the weakened German and Swiss external accounts, the limited markets for OPEC's surplus funds, and the favorable cost-competitive position of U.S. exports are all forcing an increased reliance on interest-rate differentials as a means of affecting exchange rates.

If the United States moves decisively to tighten monetary policy, Europe's hard-currency countries will have little choice but to accept more-restrictive monetary policies themselves. But if the markets are disappointed by U.S. measures, Germany and Switzerland may once again enjoy exchange-rate strength without having to raise their interest rates further.

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Foreign trade a source of Canadian economic strength.

Canadian foreign trade is holding up well despite the threat of a U.S. recession. The trade balance posted a surplus of C$4 billion last year, well above the C$3.4-billion surplus of 1978. Although the monthly trade surplus declined in January 1980, it was still running at an annual rate of about C$3.5 billion. The export sectors showing the greatest strength were oil and gas, chemicals, trucks, non-ferrous metals, and agricultural machinery. And sales have been brisk not only to the United States—which absorbs 70% of Canadian exports—but to Europe and Japan as well. The strong trade performance has boosted the value of the Canadian dollar and helped raise international reserves (less gold) from $2.8 billion in December to $3.5 billion in February. If export earnings maintain their present pace, Canada will be able to offset rising service payments and keep its current-account deficit from widening much beyond the C$5.3 billion estimated for 1979.

New Irish budget strives for austerity.

The new Irish budget, unveiled on February 27, marks a major shift in economic policy. Since 1977, the Government has sought to sustain rapid growth through highly expansionary fiscal and monetary policy. The policy worked well for a while, giving Ireland one of the fastest growth rates in Europe. But problems emerged in the form of an expanding budget deficit, a widening current-account gap, and accelerating inflation. The new budget is aimed at alleviating these imbalances, at the expense of economic growth. Public expenditures will be curbed so as to reduce official borrowing needs from about 14% of GNP to 10%. At the same time, the Government will increase its share of revenues from sales taxes relative to income taxes in response to taxpayer complaints. These initiatives are expected to help trim economic growth to about 2% this year, compared with 3.5% in 1979 and 5.9% in 1978. This reduced growth should in turn prevent a widening of the $1.6-billion balance-of-payments deficit posted last year. A problem is the extent to which the higher sales taxes trigger higher wage grants, since the high inflation rate—expected to run at 17% in 1980—could persist and compromise Ireland's membership in the European Monetary System.

Belgium's tight money policy aims to bolster the franc's exchange value.

In line with higher interest rates in Germany, Switzerland, and the United States, Belgium recently raised its central bank discount rate from 10.5% to 12%. With the year-on-year inflation rate at 6% in January, the discount rate is now six percentage points above the inflation rate, an unusually large differential. This degree of monetary tightness was necessitated by the weakness of the Belgian franc within the European Monetary System, which in turn was largely the result of the combined current-account deficit of Belgium and Luxembourg. This deficit rose to an estimated $3.3 billion in 1979 from $900 million in 1978. With the expectation of reduced export growth in 1980 and oil prices averaging 60% higher than in 1979, the 1980 current-account deficit may climb as high as $4 billion, forcing the continuation of high interest rates to protect the franc in the EMS.

Danish policy stringency limited by political considerations.

Denmark's persistent balance-of-payments deficit widened to kr. 15.6 billion in 1979 from kr. 8.2 billion in 1978. Simultaneously, the country's annualized inflation rate rose from 6.7% at the start of 1979 to 11.9% at year-end. The authorities have responded with successive devaluations of the kroner and increases in interest rates to sustain capital inflows and dampen domestic demand. The kroner was devalued by about 3% in September and by another 5% in November 1979, while the central bank discount rate was raised from 9% to 11% in September 1979 and to a record 13% in February 1980. Attempts to introduce a stringent incomes policy, however, have been thwarted by the need to preserve the fragile coalition government formed after the general election of October 23. In the absence of tougher measures that might turn the economy around, the 1980 current-account deficit will likely approximate the 1979 shortfall, while inflation will average some 10.5%. Thus, Denmark will be forced to continue living on borrowed time, supporting its very high standard of living—per capita income is about 11.5% higher than in the United States—by borrowing more abroad and increasing a foreign debt burden that is already equivalent to 20% of GNP.

Pakistani current-account deterioration will require more foreign borrowing.

Pakistan's current-account balance is on a steady downtrend in the current fiscal year (ending in June). Although export growth was about 50% in the first half of the fiscal year, earnings in the second half will be hurt by the slowdown in world trade. Total export receipts will nonetheless reach approximately $2.2 billion, topping the official target of $1.9 billion. While imports are weakening as a result of stepped-up controls and higher import taxes, they are expected to increase by some 12% because of soaring oil prices. The trade deficit is thus likely to remain in the area of $2.1 billion, roughly the same as last year. But in view of the decline in worker remittances from abroad and higher interest payments on debt, the surplus in the invisibles account is expected to narrow to about $700 million from $1 billion last fiscal year. The current account will therefore be about $1.4 billion in the red, compared with a $1-billion deficit last year. And financing the deficit will further enlarge Pakistan's already heavy debt burden.

New Thai leadership faced with task of selling energy price hikes.

Thailand's new prime minister is not expected to alter the course of government policy in any major way. But he must now address the economic issues that led to his predecessor's departure. The most critical of these is the need to win public approval of large price increases for oil products, electricity, and other energy-related goods necessitated by the sharp rise in imported oil costs. The sharpest increases apply to diesel fuel, kerosene, and cooking gas, all politically sensitive items that were underpriced for years. Rescinding or modifying these increases would calm public protest but saddle the Government with heavy subsidies. The new prime minister will need to appoint a chief economic minister strong enough to win public endorsement on this and other difficult issues.

Peruvian economy strengthens.

Peru's economy experienced a remarkable turnaround in 1979. The combination of restrictive demand-management policies, corrective price and exchange-rate adjustments, unexpected terms-of-trade improvements, and successful export promotion efforts have enhanced the country's fiscal and external position and have reversed the deterioration in economic activity. The central government deficit shrank from 5% of GDP in 1978 to 1.6% last year, while the current account of the balance of payments shifted from a deficit of $190 million in 1978 to a surplus of $590 million. The improvement in the external sector allowed the authorities to obtain a waiver on the debt rescheduling negotiated in late 1978, and to prepay 1979 maturities. As for economic growth, real GDP is estimated to have advanced about 2.8% following two years of decline, with most of the gains concentrated in the export-oriented sectors. Nevertheless, two major problems remain unresolved: an inflation rate that continues in the 70% range and widespread unemployment.

U.S. and Soviet purchases will keep wheat prices firm.

Wheat prices initially fell following the January 4 announcement by the United States that grain sales to the Soviet Union would be curtailed. Earlier this month, when the Department of Agriculture announced it would begin to implement its program to buy 4.5 million tons of wheat denied the Russians, prices rose sharply but still remained below their extremely high pre-embargo level. Since then, they have come down again in response to good weather conditions for the winter 1980 crop and soaring interest rates, a depressing influence on most commodities at this time. Wheat prices are expected to fluctuate around current levels over the next few months and eventually move higher, as U.S. Government purchases are sustained and as the Soviet Union continues to increase its grain imports from other countries.

New Pressure for Deposit Costs

Pressures on deposit costs of banks and thrift institutions are likely to intensify in coming weeks. An important contributing factor will be the higher interest rates applying to renewals of maturing 6-month money market certificates (MMCs) issued by banks and thrifts. Indeed, in view of present earnings problems at certain institutions, there has been increasing discussion of the possibility that regulatory agencies may impose new constraints on the rates of interest that may be offered on MMCs.

Money market certificates were first introduced in mid-1978. The maximum rate presently authorized for MMCs is the average new-issue rate on six-month U.S. Treasury bills. Over the past year-and-a-half the growth of these instruments has far exceeded expectations—as, of course, has the rise of interest rates generally. At the end of January 1980 outstanding certificates amounted to $290 billion, of which around $137 billion, or 47%, was at savings and loan associations (S&Ls) and $116 billion, or 40%, was at commercial banks. MMCs have accounted for a steadily rising share of the funding of many institutions—for example, they are almost 30% of total savings at S&Ls and over 25% at savings banks.

The new pressures on the earnings of many institutions will be especially troublesome during April, when an unusually large amount of MMCs will mature. These represent certificates written in October 1979. That month's net increase in MMCs approximated $31½ billion, one of the largest increases in a single month since these instruments were introduced. Last October rates on new six-month Treasury bills averaged "only" 11.34%; the rate is currently around 15%.

Regulators face a dilemma. It will be difficult to insulate hard-pressed institutions from the full effects of current interest rate levels without encouraging depositors to invest their funds elsewhere. There has been some effort of late to provide a partial resolution. Last December, agencies authorized a new long-term consumer CD having a maturity of 2½ years or more and a maximum yield tied to that of Treasury securities. This new certificate was apparently quite popular with consumers. But late in February regulators imposed a new absolute ceiling of 11¾% for banks and 12% for savings banks and S&Ls. (On the previous basis, the 2½ year ceiling for banks in March would have been about 13⅜%.) Regulators justified the ceiling change by the assertion that market rates on such instruments were not warranted, in view of current rates of return on those long-term assets in which such funds would be invested. A similar kind of rate cap mechanism may be ahead for the MMCs. Such a move by regulators, however, could add new liquidity problems to the profitability pressures already facing many institutions.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE			
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest date	reserves (less gold) in million $	12-month change	months of imports covered
Africa	Algeria	Plan for 1980-84 will give higher priority to agriculture and social development.	Dec.	+ 49%	19.3*	$ 1,075	Jan.	2,726	+ 54%	4.9
	Angola	New foreign investment law permits foreign private investment via joint ventures with Government.	Dec. '78	+ 6%	2.6	407	Dec. '78	295	n.a.	4.0
	Burundi	New investment code being prepared, with aim of attracting foreign capital for development.	Sept.	+127%	0.6	140	Dec.	90	+ 11%	1.0
	Egypt	Agreement reportedly reached with IMF on new 3-year credit for $650-$700 million.	Sept.	+128%	18.8*	464	Nov.	367	− 12%	1.5
	Gabon	Concentration on productive development projects should return economy to growth path.	Dec.	+ 24%	3.6**	3,800	Sept.	11	+ 49%	1.0
	Ghana	Budget of $1.3 billion for 1979/80 is 19% above 1978/79.	n.a.	n.a.	14.3*	130	Oct.	283	+ 14%	n.a.
	Kenya	Heavy defense spending implies substantial foreign borrowing.	Aug.	+ 32%	5.5	370	Dec.	625	+ 77%	4.7
	Madagascar	Development plan for 1978-84 emphasizes light industry.	Mar. '79	− 14%	2.0	240	Aug.	63	− 30%	1.8
	Morocco	Government austerity measures restraining economic activity.	June	+ 19%	12.8	678	Dec.	557	− 10%	2.1
	Nigeria	Agricultural production seen expanding at 2% pace for second consecutive year.	Nov.	+ 69%	41.4	520	Dec.	5,548	+194%	4.3
	South Africa	Invulnerability to oil price rises boosts business and consumer confidence.	Oct.	+ 36%	46.7	1,650	Jan.	654	+ 37%	0.6
	Tunisia	France provides $108 million in loans for industrial and other development.	Sept.	+ 84%	5.8	936	Jan.	543	+ 20%	2.4
	Zaire	GDP stagnated in 1979, following four years of decline.	Mar. '79	+ 28%	6.4	230	Nov.	294	+ 73%	6.0
Middle East	Iran	Work to resume with Japan on large Bandar Khomeini petrochemical project.	Dec.	+ 55%	76.4*	2,227	Nov.	14,715	+ 28%	n.a.
	Jordan	Higher oil import costs prompt increase in domestic prices of petroleum products.	Dec. '78	+ 34%	2.3	587	Jan.	1,118	+ 23%	9.0
	Kuwait	Domestic exploration for oil to be stepped up.	Dec.	+ 82%	13.9***	12,278	Jan.	2,504†	− 4%	7.0
	Saudi Arabia	Budget expenditure target for 1979/80 reportedly raised 25% to about $59½ billion.	Dec.	+ 68%	54.5***	8,400	Dec.	19,273†	0	10.5
	United Arab Emirates	Abu Dhabi development outlay budgeted at $2 billion, up 20% from 1979.	Dec.	+ 88%	13.2*	17,820	Jan.	1,162†	+ 64%	2.6

*1977 **1979 ***FY 1977/78 †Excluding state rese

Auto Sales Shift Into Low Gear

The U.S. auto industry is bracing for what may prove to be its worst sales year since 1975. Buffeted on the one hand by increased foreign competition and on the other by stiffening consumer resistance, sales of domestically made cars in February fell to nearly 15% below year-ago levels.

As with most durable goods, the demand for autos is strongly influenced by cyclical movements of the economy. In particular, an individual's decision to purchase a new car is highly responsive to changes in real disposable income. Over the past six months alone, consumers have seen their real incomes decline by almost 1%. Economists fear that further deterioration is likely. In addition, consumers' ability to supplement their real incomes by cheap and easy borrowing and by drawing down savings may at last be tapering off. Personal saving is at an historically low level and record high interest rates in recent weeks have dramatically dampened the growth of consumer debt, which is especially important to new auto sales. Finally, the prevailing uncertainty over future economic conditions may be prompting consumers to delay purchasing new autos.

The economic uncertainty at home is compounded by the political uncertainty in the Middle East. With continued anxiety over gasoline prices and availability, American car buyers have demonstrated a growing preference for smaller, more fuel-efficient models. As a result, domestic auto makers have been increasingly hard hit by foreign competition. Import sales were up again in February as overseas manufacturers captured more than 27% of the U.S. new car market—a record share for the second month in a row.

One unfortunate byproduct of dramatic Japanese gains in the U.S. market has been a resurgence of protectionist saber rattling in Congress. Advocates of trade restrictions to protect the domestic auto market point to U.S. car makers' drastic production cutbacks and layoffs of some 200,000 American auto workers. Some U.S. lawmakers have warned that new protectionist legislation is imminent unless Japanese auto manufacturers either curtail their car sales to the United States (which in 1979 accounted for 40% of Japanese auto exports) or follow the example of another foreign car maker and set up plants in America. But with the exception of one auto producer, Japanese car manufacturers thus far seem inclined to take their chances that the United States will not impose drastic restrictions on auto imports—primarily, they say, because they do not expect their present competitive advantage to last.

U.S. manufacturers themselves have high hopes that sluggish sales will greatly improve in September when they introduce new models designed to meet the foreign competition head-on. Even then, much will depend on the state of the economy and consumer confidence. But at least over the next several months, there is little prospect of any sales turnaround.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF, mil- dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	domestic credit	central bank rate March 12, 1980	exchange rate in U.S. dollars March 12, 1980	current monetary conditions	
	Sharp increase in LNG export prices sought.	Dec. 78	+ 17%	July	+ 30%	—	.2725	Banque Nationale raises $200 million Euroloan.	Algeria
	Oil earnings could reach $2 billion in 1980.	n.a.	n.a.	n.a.	n.a.	—	.04	Brazil grants $30-million export credit.	Angola
	Coffee earnings up sharply in second-half 1979, but imports also jumped.	Dec. '78	+ 31%	Sept.	+ 69%	—	.0113	Credit squeeze in effect.	Burundi
	Rising world price will raise cotton export revenues.	Sept.	+ 14%	Nov.	+ 59%	9.00%	1.45	Interest payments on official Arab deposits to resume.	Egypt
	Oil receipts should rise in 1980 as high prices offset 10% output cut.	Nov.	+ 7%	Sept.	− 2%	—	.0048	Credit policy remains restrictive.	Gabon
	Oil bill was $285 million in 1979, while ban on timber exports hurt receipts.	Dec.	+116%	Sept.	+ 16%	13.50%	.3700	Credit highly restrictive.	Ghana
	Import deposits relaxed on essentials; selected controls remain.	Nov.	+ 8%	Oct.	+ 11%	—	.1415	Credit restraint continues.	Kenya
	Rice imports responsible for 75% of trade deficit.	June	+ 12%	Aug.	+ 52%	5.50%	.0049	Central bank coordinates credit expansion.	Madagascar
	Higher world price will increase phosphate rock revenues this year.	Mar. '79	+ 10%	Sept.	+ 20%	4.50%	.2700	Claims on private sector rising slowly.	Morocco
	Oil receipts in 1980 should exceed $25 billion.	May	+ 8%	July	+ 14%	5.00%	1.87	International reserves spurt.	Nigeria
	Anticipated inventory restocking should stimulate increased imports.	Nov.	+ 14%	Oct.	+ 11%	7.00%	1.2425	Money conditions restrictive.	South Africa
	Sharp rise in imports last year offset by increased oil revenues.	Nov.	+ 10%	Nov.	+ 7%	5.75%	2.55	Money supply rising steadily.	Tunisia
	Official debt of $1.3 billion rescheduled.	Oct.	+ 93%	Sept.	+ 37%	—	.3450	Credit restraint continues.	Zaire
	Gas exports to Soviet Union down sharply.	Nov.	+ 9%	June	+ 36%	9.00%	n.a.	Interest payments to be replaced by commissions.	Iran
	Foreign aid inflow and remittances boost reserves to $1.1 billion in January.	Nov.	+ 13%	Nov.	+ 33%	5.50%	3.40	Central bank raises interest rates payable on deposits.	Jordan
	Oil output cut of 25% expected in April.	Sept.	+ 5%	Nov.	+ 44%‡	—	3.64	Interest rates on short-term KD loans rising.	Kuwait
	Oil output averaged 9.25 million bpd last year, up 15% from 1978.	Sept.	+ 2%	Sept.	+ 75%‡	—	.3005	Claims on private sector rising steadily.	Saudi Arabia
	Dubai output averaged 354,000 bpd in 1979, down 2.3% from 1978.	n.a.	n.a.	Nov.	+ 12%‡	—	.2685	New Central Bank Law to be announced soon.	United Arab Emirates

‡Private sector only

World Interest Rates

market rates of March 12, 1980; bond yields as of March 7, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	14.00	17.00	12.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	7.25
Day-to-Day Money	16.50 Mar. 13	10.00	17.00	12.75	13.50	8.80	16.625	10.50	5.125	9.625
Treasury Bills 91-day, Middle Rates	15.60	14.10	16.00	n. a.	14.67 1-year	n. a.	14.85 80-days	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	14.50 finance paper 15% tax w/h	15.44	11.90 Certified	14.1875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.90	14.40 15% tax w/h	17.4375	13.75 Certified	not traded	8.40	18.45	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.39	13.625	14.48	11.03 20% tax w/h	13.44	9.29	14.54	11.20	4.88	9.10
Industrial Bonds prime, long-term, new and old issues, average yield	13.40 Aa Industrials	14.25	14.79	13.81 20% tax w/h	14.78	9.17	14.74	12.08	5.80	6.97
Bank Short-Term Rate to Best Borrowers (prime rate)	18.25*	15.00	18.50	16.75	14.10	9.75	20.00	14.00	4.50	7.50
Bank Time Deposits 3-month	16.50 Cert. of Dep.	14.40 Cert. of Dep.	17.75	15.50	14.1875	9.35	10.75	12.00 large deposits	6.75 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.25	no market	18.625	no market	15.375	6.875	no market	13.00	6.875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8559	2.2315	.034060	.2365	.5532	.001189	.5033	.5788	.004041
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	4.25 *P*	FLAT	1.375 *P*	4.00 *P*	8.875 *P*	2.75 *D*	6.00 *P*	11.375 *P*	4.725 *P*

Eurodollar Deposits

(London, interbank, bid)
March 13

7-day	16.50
1-month	18.00
3-month	18.5625
6-month	18.4375

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .18
U.S.-Canada Treasury Bills	−2.08
U.S.-Canada Finance Co. Paper	−3.55
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.25
DM Bonds	
7 yrs. and under	8.50
Over 7 yrs.	8.75

Gold Price

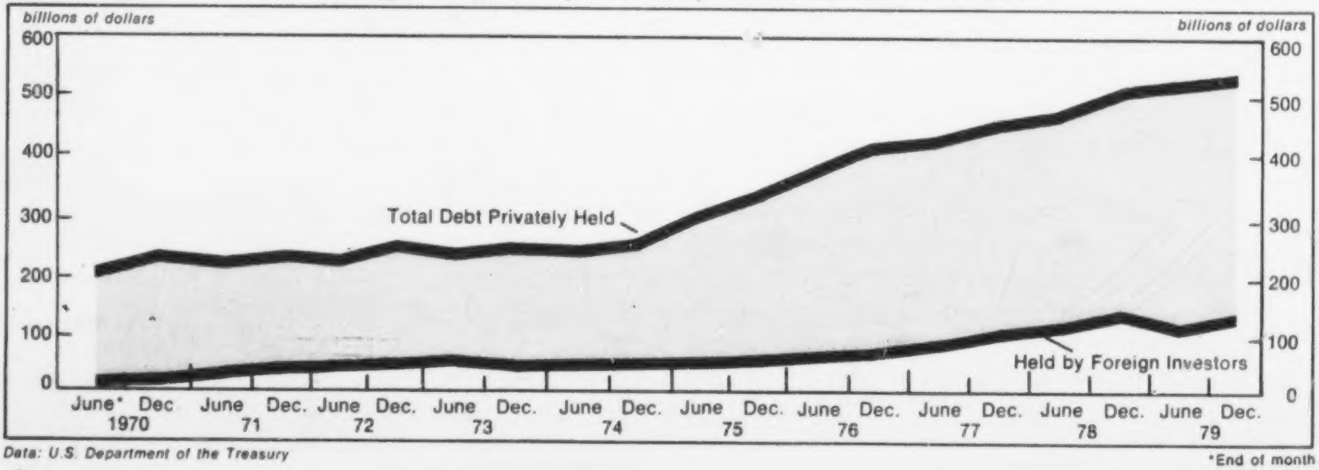
London
afternoon fixing

585.70
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Effective Mar. 13.

Foreign ownership of U.S. public debt on the rise



Data: U.S. Department of the Treasury

*End of month

The Changing Nature of U.S. Public Debt

The public debt of the U.S. Government has soared more than 70% in the last five years. As of the end of 1979, the total interest-bearing debt outstanding was $832 billion, an increase of $50 billion in just one year. This debt includes not only borrowing by the Treasury to cover the ordinary budget deficit, which was $28 billion in fiscal 1979, but also funds channeled through various credit programs administered by agencies of the U.S. Government. Interest on the public debt—$60 billion in fiscal 1979—will be more than $70 billion this fiscal year and may exceed $80 billion in fiscal 1981.

Conventional wisdom maintains that the existence of a large debt is not a net burden if it is all held domestically. Under these circumstances, the major effect of public debt is a redistribution of income from the general taxpayer to holders of public debt securities. The largest holders are various official trust accounts, such as the Highway Trust Fund and the Social Security Trust funds. According to the Treasury, these government accounts held about 22% of the total outstanding Federal securities as of November 30, 1979, while another 14% or so was held by the Federal Reserve banks.

The general public held the remaining 64%, or $527 billion. Of this amount, foreign investors, chiefly official institutions, held $121 billion. This large portfolio was acquired quite rapidly by foreign investors in the 1970s. At the end of World War II, foreigners held just 1% of the private debt, and still only 8% as recently as 1970. Although the volume of privately held Treasury debt more than doubled in the last decade, the accumulation by foreign investors skyrocketed six-fold, boosting their share to nearly 23% (see chart on opposite page).

Why the debt piled up

Around 1970, two major structural changes occurred in the U.S. economy. First, to help sustain the rapid economic growth to which the country had become accustomed in the 1950s and 1960s—made possible in part by cheap energy—the Government allowed oil imports to double between 1969 and 1973. The subsequent Arab embargo was thus rendered more effective, and the price of oil quadrupled in 1973-74. The higher energy prices reduced potential output by adversely affecting capital investment and hence, labor productivity. Despite this loss of future wealth, the U.S. dependence on imported oil continued to grow. In 1979, oil prices doubled, once again lowering the growth path of real potential output.

Second, concern about worker safety and the environment led to a spate of new regulatory legislation, mandating capital spending during the 1970s that did not result in measured output. As a result, the growth path of potential output moved still lower.

Policymakers failed to recognize, or chose not to concede, that these changes would prevent the U.S. economy from growing as fast as it did during the 1960s. As a result, two sets of forces were set in motion that served to widen budget deficits. The slower-growing economy generated smaller receipts than expected. And the Government attempted to increase output by cutting taxes and increasing spending. In this situation, the Federal Reserve and government trust funds absorbed their historic share of increases in the public debt. But commercial banks and private citizens did not. Their holdings increased by only 55%, although the total outstanding Federal debt more than doubled.

Foreign official institutions picked up the slack, albeit perhaps unintentionally. With U.S. inflation accelerating in 1977 and 1978, the Fed was somewhat unwilling to let interest rates rise sufficiently to prevent the dollar from depreciating against foreign currencies. In attempts to stabilize exchange rates, foreign official institutions acquired dollars. To earn interest on these assets, they exchanged these dollars for Treasury securities. Indeed, from June 1976 to December 1978, foreign investors acquired nearly $70 billion of Treasury securities. Thus, the effect of fiscal and monetary policies was to attract official capital flows from abroad.

When the dollar strengthened in the first half of 1979, foreign central banks reduced their holdings of U.S. debt at a rapid rate as they sold dollars to limit the depreciation of their currencies. This intervention put some upward pressure on interest rates for U.S. Treasury bills. However, total capital flows may not have been affected. Outflows of official capital were more than offset by inflows of private capital, which accelerated during this period. This divergence of private and official capital flows is almost certainly being repeated in the current episode of dollar strength.

Despite the drawdowns of the past year, foreign holdings of U.S. public debt are still substantial. Billions of dollars of U.S. national income continue to flow abroad to pay the interest. But more importantly, the United States has surrendered a certain degree of control over its monetary affairs to foreign central banks. As long as the existing cooperation is maintained, the U.S. Government will undoubtedly continue to accrue some benefits of lower interest costs, and domestic economic growth will be somewhat greater than it otherwise would be. But at some point, the costs of transferring wealth abroad and of reduced monetary control may eventually come to outweigh the benefits.

Douglas L. Bendt

Israel Pursues a Policy of Austerity

The Israeli economy posted a strong 5.2% real GDP growth rate in 1979, but not without an alarming increase in inflation. Private consumption increased 7% in volume terms as the combination of higher real incomes and easy credit led to heavy purchases of consumer durables. Indeed, house prices rose by about 160%, spurring an 11.5% real increase in investment in construction. Output in other sectors of the economy remained fairly flat over the course of year. Government current expenditures, on the other hand, are estimated to have declined 3.5%, largely a result of reduced defense spending. On the external front, strong growth in import volume combined with higher oil prices to widen the trade deficit to $4.1 billion.

The Israeli authorities are now confronted with several serious problems. The most pressing is inflation. Consumer prices rose at an annual rate of 114% in December. And any reduction in the pace of price increases is complicated by widespread indexation of wages, government spending, and interest rates on government bonds.

A second problem is the continued rapid expansion of domestic credit, fueled by government deficit spending. Bank lending to the public has increased in both local and foreign currency terms. The actual degree of monetary growth is difficult to interpret, however, owing to a widespread flight into foreign currency. This flight accelerated in mid-February amidst uncertainty following the introduction of the new Israeli currency, the shekel. The shekel was introduced as a replacement for the battered pound in an effort to restore faith in local currency; it is valued at ten times the pound.

The third problem is the loss of export competitiveness stemming from the Israeli currency's depreciation by less than the rate warranted by the inflation differential between Israel and its trading partners. The impact on exports in 1979 was to hold the growth in export volume to only 1.6%. Import volume, on the other hand, rose 8%, and sharply higher oil prices aggravated the cost burden—widening the trade deficit from $2.8 billion in 1978 to $4.1 billion last year. Israel's larger deficit is related in part to its return to Egypt of the Sinai oil fields, which had been supplying 20% of its domestic requirements.

The appointment of a new finance minister last November resulted in the unveiling of an ambitious austerity program aimed at alleviating these problems. The package included a partial credit freeze, an increase in import duties, and a reduction in price subsidies and public-sector manpower. Three further actions (or omissions) highlight the resolve of the authorities to give priority to fighting inflation. First, Israelis earning above-average incomes did not receive the full cost-of-living supplement payable in January. The maximum supplement was held to 3,366 Israeli pounds, an amount equal to full indexation only for average-income earners. Second, no adjustments in tax brackets were made to compensate for inflation, thereby bringing about a decline in purchasing power at all income levels. And third, total government spending envisaged in the fiscal 1980 budget was cut nearly 5% in real terms.

The austerity measures are already having effects on the economy. Consumer spending appears to be slowing and credit growth is declining. If the current policy stance is sustained and the budget proposals implemented, economic growth will fall sharply during the rest of the year. In fact, real GDP is unlikely to increase by much more than 2%.

Such a slowdown would have a favorable impact on inflation in the medium term. But in the short run, several factors will work to stimulate further price rises. First is the continued acceleration in labor and other input costs, and second is the reduction of price subsidies on certain commodities. Accordingly, Israeli inflation could average 120% for 1980 as a whole. And in the external sector, the higher oil prices are expected to widen the trade deficit further.

While adherence to a strict austerity program would permit an improvement on both the inflation and external-account fronts, there are several constraints on the pursuit of current restrictive policies:

- Defense accounts for one-third of total government expenditures, while another third is allocated to the repayment of external debt. Therefore, any reduced government spending must inevitably affect industrial and social programs.
- The dampening impact of tight monetary policy on manufacturing, combined with the anticipated further erosion of exports because of reduced competitiveness (owing to an overvalued currency), threatens to boost unemployment beyond 4%. The average annual unemployment rate has not exceeded that level in the last decade, and such a development is thought to be politically unacceptable.

In view of these constraints, it is likely that a new policy initiative will be forthcoming. And it may very well respond to political pressure to reverse course from current free-market principles. A new initiative could take the form of tighter import controls and a temporary freeze on prices and incomes. Also possible is a gradual unwinding of indexation, particularly in the government finance area. In any event, the adjustment of the economy to a more stable equilibrium path over the next couple of years is likely to increase Israel's reliance on external financing.

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CHASE

International Finance

Vol. XV, No. 7
March 31, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

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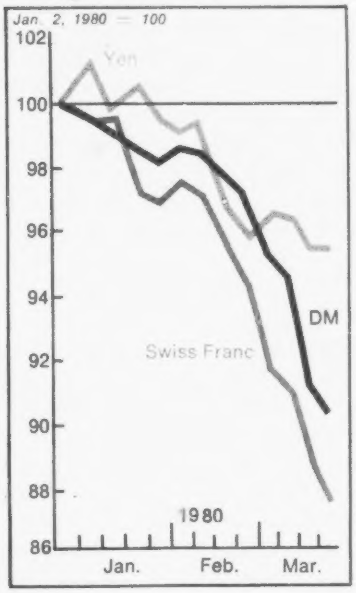
The Strong Dollar Creates Problems

The dollar problem is pinching once again, but now the shoes are on other feet. This time it is not the United States that is facing the threat of imported inflation and loss of freedom with respect to domestic monetary policy, but rather Germany and Japan—the strong-currency countries of recent years. Since the beginning of January, the dollar has appreciated roughly 10% against the Deutschemark, 13% against the Swiss franc, and 4% against the Japanese yen. These exchange-rate movements have added to the rapid increase in the local-currency cost of imported goods, which has been the primary factor behind the acceleration of consumer-price inflation in these countries. And dollar strength has played a pivotal role in influencing the adoption of monetary policies abroad that have become tighter than most foreign policymakers would have preferred at this time.

Dollar cost of selected foreign currencies



The policy responses in those countries most affected by the strengthening dollar have been similar. Short-term interest rates have been pushed up, the access of foreign investors to local financial markets has been liberalized, off-market exchanges of domestic-currency denominated securities for dollars are being negotiated with OPEC surplus countries, and extensive intervention in foreign-exchange markets has been carried out. To some observers, these actions amount to a reversal of long-standing policies aimed at preventing these currencies from assuming a wider international role. This characterization seems extreme. The recent policy moves are essentially currency-defense packages that can be expected to be reversed when the balance of forces affecting the dollar changes sign.

A second perception that seems exaggerated is the notion that the period of troublesome dollar strength is likely to be protracted. The recent surge of the dollar has derived primarily from the emergence of unusually wide interest-rate differentials. The foreign-exchange market views these differentials as favoring dollar-denominated assets to an abnormal degree, given expectations as to underlying inflation rates. Projection of the course of U.S. interest rates in the coming months is extremely hazardous, and there is certainly no consensus as to whether these interest-rate differentials will widen or narrow in the short run. But it does seem a fair bet that the current wide disparity in interest rates will not persist for an extended period.

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Dutch under strong pressure to enhance trade performance.

The Dutch current account is estimated to have posted a deficit of 4.5 billion guilders in 1979, well above the $1.5-billion guilder official estimate offered at the start of 1980. Largely responsible for the marked deterioration are the rise in oil prices in the fourth quarter of last year and delays in raising the price of Holland's natural gas exports. Private forecasters fear a current-account gap as large as 5 billion guilders in 1980, giving added urgency to efforts to improve export competitiveness. In this context, the recently proposed incomes policy, which most expect to be approved by parliament and which will restrict real wage increases for all but the low-paid to less than 1%, should have a positive impact on the 1980 trade accounts. The policy is expected to prevent a further deterioration in export competitiveness and restrict the growth of aggregate demand, now forecast to rise by 1% in real terms this year.

Rising inflation in Norway complicates wage bargaining.

Increasing oil production helped swing the Norwegian trade account into a surplus of 330 million kroner in February, after January's kr. 84-million deficit. The trade-account improvement triggered healthy demand for the kroner on foreign-exchange markets, leading the central bank to intervene to dampen upward pressure. The future, however, looks somewhat less rosy. Consumer prices have begun to accelerate sharply, with prices rising 1.4% in January and 1.3% in February. The increased pace of inflation is threatening the current wage negotiations, and some labor groups have already struck for immediate pay raises, refusing to wait until the negotiations are concluded. Other similar labor actions underscore the restiveness of the workforce. If wage settlements come in at high levels, the competitiveness of Norway's traditional industries will be hurt, thereby threatening a rise in unemployment as the year progresses.

Portuguese authorities set ambitious 1980 growth targets.

Portugal's current account staged a major recovery in 1979, shifting into surplus as a result of strong growth in tourism, manufacturing exports, and worker remittances. The economic program of the newly elected government seeks to build on this performance, in the hope of making a solid and immediate impact before the required 1980 general election. Government targets for 1980 specify a reduction in annualized inflation from 24% to 20%, an increase in economic growth of 2.5%-3.5%, and—for the first time since 1975—no decline in real wages. The escudo was revalued by 6% in February, but the monthly crawling peg devaluations of 0.75% will remain in effect. The net impact of this, together with continuing price controls and subsidies, is expected to be a slower pace of inflation without significant erosion of export competitiveness. The growth targets, however, appear overly ambitious in light of the world economic slowdown and sustained domestic monetary restraint.

Japan responds to mounting inflation with new program.

Faced with accelerating inflation, the Japanese Government announced another anti-inflation package. The new plan is designed to hold the rate of price increases to within the official target of 6.4% for fiscal 1980/81. In addition to a record rise in the discount rate to 9% and generally tighter monetary policy, a more stringent fiscal policy will be implemented. Some public work projects will be postponed, public services charges will be reduced, and energy and land price rises will be monitored closely. The Government also intends to stabilize food prices by modernizing production and distribution methods; it may also increase beef and marine product imports to ease shortages. The anti-inflation package, however, lacks the specific measures that will be taken by the Government to achieve its goals; thus, there is some doubt as to whether the program will have a significant impact on the economy. Assuming that the effects are limited, Japan's inflation rate for the next fiscal year will very likely be in the 9%-10% range.

Hong Kong looks forward to continued high growth.

The Hong Kong Government anticipates continued prosperity in 1980. The authorities project that GNP will advance by 9%, compared with 11.5% growth in 1979, and that the rate of consumer price inflation will decline from the 11.6% rate of last year to about 10%. Private and public property development and business and financial services will remain the leading sectors of the economy, buoyed by the gathering momentum of Chinese economic development. China-related business is expected to moderate the impact of economic sluggishness in the Western economies. Nevertheless, exports are unlikely to grow by more than 7% in real terms, versus 16.6% growth in 1979. Imports, however, will advance about 11%, and a trade deficit exceeding $2 billion is anticipated. Invisible earnings and investment inflows are expected to cover the trade gap, thereby maintaining stability in the Hong Kong dollar's exchange rate.

Colombian reserves reach historic high.

Colombia's official international reserves rose by $1.6 billion in 1979–much greater than the two previous years combined–to a record $4.1 billion. This unusually strong performance is attributable to gains in both the current and capital accounts of the balance of payments. Specifically, significant advances in noncoffee exports and service earnings widened the current-account surplus from $800 million in 1978 to $1.2 billion last year. At the same time, higher levels of public and private foreign borrowing produced a capital-account surplus of $465 million in 1979, compared with deficits averaging $155 million annually in the previous two years. The growth in international reserves is putting pressure on the expansion of the monetary aggregates, although the rate of inflation has eased in the past two months.

Cameroon's rising oil output improves medium-term balance-of-payments outlook.

While still highly dependent on cocoa and coffee for foreign-exchange earnings, Cameroon is about to enter a period of stepped-up oil production and exports, followed by export diversification. In 1979, the oil account is estimated to have been in approximate balance, as export receipts for about 1.2 million tons of crude were offset by import payments for refined oil products. By 1982, Cameroon's domestic oil needs, projected to rise to one million tons, should be supplied entirely by the new Victoria refinery. As production is forecast to reach 3-3.5 million tons in 1982, net oil receipts could approach $1 billion. Furthermore, recent offshore oil finds give rise to production forecasts of 5 million tons by 1983-84, with a possible doubling by the end of the decade. Given Cameroon's conservative economic management, substantial current-account surpluses are foreseen for the mid-1980s, which should facilitate the infrastructural development needed to exploit the country's rich natural resources. This should broaden the export base and reduce dependence on agricultural exports for foreign-exchange earnings.

Gold fever turns to chill.

The precious metals markets have become increasingly volatile as the United States and other economies appear poised on the brink of a recession, with accelerating inflation and rising interest rates. Gold's price soared to over $850 per ounce in January from year-earlier levels of slightly more than $200. Since then, prices have fallen back to the $500-range, despite higher rates of inflation. The reasons for the price decline include an easing of the war anxiety that was sparked by the Soviet invasion of Afghanistan, a rise in the value of the dollar in response to sharply higher interest rates, and the imposition of credit controls and stepped-up efforts by both the Carter Administration and Congress to balance the U.S. budget. Although gold prices may recover again in coming months if prospects for inflation worsen, the dollar weakens, or new political turmoil erupts–especially in the Mid-East–the most likely gold price trend over the next year is downward. This assumes that the much-heralded recession arrives soon, as is expected, and that inflation begins to subside later in the year.

Housing's Foundation Gives Way

Although the U.S. economy has so far stubbornly resisted recession, the housing industry is headed for one of its worst years since 1946. Housing units were started at a seasonally adjusted annual rate of 1.33 million in February, almost 30% below September 1979. And the turnover rate of new houses has slowed about 20%. Further, the sales rate for existing houses has fallen about 25% to a seasonally adjusted annual rate of 2.95 million in February, the lowest rate since May 1976.

Housing activity had started to slow somewhat during the first nine months of 1979. Starts and sales of new housing units were off about 10% from the corresponding 1978 level, but the sales pace of existing homes was off by only 5%. As mortgage rates moved over 10% and approached 12% in many areas, many observers were amazed that activity did not fall off more. The reason for the resilience has much to do with the fact that the annual rate of price increases of new and existing houses was averaging about 15%. Thus, demand for housing and mortgage credit remained high as people sought to purchase homes as a hedge against further inflation. And the success of the six-month money market certificates, along with other short-term borrowing, allowed thrift institutions and banks to increase the supply of long-term mortgages.

Several factors in the last six months have dramatically altered the perspective of both borrowers and lenders. First, mortgage rates climbed past 12% (and beyond 13% in some areas) in the wake of Federal Reserve actions to tighten credit in October 1979, smacking up against mortgage usury ceilings in many states. Congressional action suspended these ceilings as of January 1, 1980. But even without such constraints, the incentives for thrift institutions to issue new commitments were drastically reduced. Earnings were squeezed as interest obligations on money-market certificates and other short-term borrowings rose faster than the average yield on mortgage portfolios. Second, as income gains lagged inflation and the sharp increase in mortgage rates, fewer and fewer households qualified for mortgage credit. And as housing markets weakened, price increases moderated to an annual rate of about 11%, easing some of the speculative demand.

Both short-term interest rates and mortgage rates have moved sharply higher in early 1980. Thus, the reduced availability of loanable mortgage funds, along with some reduction in mortgages demanded by borrowers, will bring housing activity to still lower levels in the months ahead. Building permits for new housing units were 8% lower in February than in January, signaling a further drop in residential construction activity in March. Outstanding commitments at savings and loan institutions continue to fall. And as the rest of the economy follows housing into recession, weak income gains and rising unemployment will dampen home demand still further.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF				
		3-months ending	change from year earlier	in billions of dollars	real growth	latest date	reserves (less gold) in $ million	12-month change	months of imports covered	use of credit, llions of
Austria	Economy slowing as inflation accelerates; economic growth forecast at 2% for 1980.	Aug.	+ 8.9%	68.9	+ 5.3%	Jan.	3,758	− 14.0%	2.3	0
Belgium	Domestic demand set to weaken; rise in budget deficit expected.	Nov.	+ 3.1%	111.5	+ 3.0%	Jan.	5,501	+ 34.4%	1.1	0
Britain	Indicators point to recession, but demand and output have yet to decline.	Nov.	+ 1.9%	391.2	+ 0.5%	Jan.	20,531	+ 23.9%	2.4	987
Denmark	Little economic growth anticipated for 1980; fiscal policy restrictive.	Sept.	+ 6.6%	65.6	+ 2.5%	Jan.	2,767	− 21.1%	1.8	0
Finland	Official forecasts project a slowdown, but businesses report strong orders.	Nov.	+ 8.1%	41.6	+ 7.3%	Jan.	1,743	+ 27.7%	1.8	87
France	Worsening inflation further erodes confidence; growth prospects for 1980 revised downward.	Nov.	+ 3.6%	566.9	+ 3.0%	Jan.	19,576	+ 96.2%	2.2	0
Germany	January orders remain strong, but building sector weakens.	Dec.	+ 5.7%	755.8	+ 4.3%	Jan.	51,602	+ 10.4%	3.9	0
Greece	Economy overheating, with inflation rate exceeding 20%.	Sept.	+ 6.1%	37.5	+ 3.5%	Nov.	956	− 4.1%	1.4	189
Ireland	New central bank forecast calls for GDP growth of less than 1% in 1980.	Aug.	+ 6.4%	14.9	+ 3.3%	Jan.	2,224	− 11.3%	2.7	0
Italy	Inflation year-to-year now exceeding 20%, with no immediate relief in sight.	Nov.	+ 7.3%	318.6	+ 4.0%	Jan.	19,654	+ 63.0%	3.1	0
Netherlands	Economic growth about to slow; investment weakness anticipated.	Dec.	+ 2.1%	151.8	+ 3.3%	Jan.	8,485	+ 60.1%	1.5	0
Norway	Oil development sustains rapid GDP growth; inflation surges.	Dec.	+ 0.7%	45.3	+ 2.8%	Jan.	4,238	+ 36.1%	3.7	0
Portugal	Economic growth is forecast to remain at 2.5% as second general election approaches.	June	+ 7.2%	20.2	+ 3.0%	Dec.	940	+ 7.9%	2.0	208
Spain	Recession anticipated, with 198C economic growth estimated at 0.5%.	June '78	+ 5.4%	197.4	+ 1.5%	Dec.	13,224	+ 30.8%	6.7	270
Sweden	Government cutting spending and reducing subsidies to ailing industries.	Nov.	+ 6.3%	103.3	+ 4.0%	Jan.	3,489	− 13.0%	1.4	0
Switzerland	Industrial surveys point to continued output growth in first-half 1980.	Dec.	+ 4.0%	94.1	+ 0.3%	Jan.	13,373	− 25.7%	5.3	0
Canada	Slow economic growth expected, but inflation holding below 10%; business investment strengthening.	Nov.	+ 3.1%	260.5	+ 2.9%	Feb.	3,472	+ 11.4%	0.6	0
United States	New anti-inflation program to worsen growth prospects before reducing price pressures.	Feb.	+ 0.7%	2,349.0	+ 2.0%	Jan.	9,790	+ 10.3%	0.5	0

Near-Term Money Bulge Anticipated

Although money growth has moderated considerably in March from its torrid February pace, tax-related and other seasonal forces may produce a bulge in the money supply sometime in the next few weeks. Most money supply forecasters are projecting that both M_{1a} and M_{1b} will grow at or near double-digit annualized rates in April. While such an outcome would suggest that any significant near-term easing in money market rates is unlikely, the extent to which it would precipitate further credit-tightening moves by the Federal Reserve remains unclear.

One reason to anticipate a near-term jump in the money supply is that disbursements of Federal income tax refunds, sizable since the end of February, are expected to be exceptionally large from now through at least the end of April. Tax refunds affect the narrowly-defined monetary aggregates because a significant portions of these refunds are initially deposited in checking accounts—the largest component of both M_{1a} and M_{1b}.

The last time tax refunds were extraordinarily large—when rebates were disbursed in May and June of 1975—M_1 spurted temporarily, with preliminary M_1 growth reported at almost 11% in May and 18% in June. While the magnitude of this year's tax refunds will not match those of 1975, some upward impact on money growth is likely. Indeed, it was specifically noted in the minutes of the February meeting of the Federal Reserve Open Market Committee (FOMC) that such a tax-related money bulge could occur.

Seasonal adjustments contribute another potential source of near-term strength in money growth. Current seasonal factors used to adjust the monetary aggregates do not appear to account adequately for the upward effect of seasonal forces on April money growth. Even after seasonal adjustment, April money growth in the last three years has significantly exceeded trend money growth rates.

Another near-term jump in the monetary aggregates will put them near or above the level implied by the upper-bound of their long-run target growth ranges. The extent to which the Fed would tighten interest rates further in response to such a bulge, however, is uncertain. The FOMC recognized at its February meeting that tax refunds might affect money growth in the March-April period, and this was probably taken into account when the FOMC raised the upper limit of the trading range for the Federal funds rate from 15½% to 18% from February 22 through March 7. Indeed, it is possible that this rapid increase in money market rates will, by reducing money demand, partly offset the effect of tax-related and seasonal forces on money growth. Moreover, the FOMC may feel that the transitory nature of such a bulge does not warrant any significant policy move. Unfortunately, the near-term targets for money growth set at the March FOMC meeting are not yet known. Consequently, the extent to which these targets allow for any "tax-refund" effect remains to be seen.

PAYMENTS		MONEY AND BANKING							COUNTRIES
F li- lers	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
		latest data	consumer prices	latest data	domestic credit	March 26, 1980			
	Export prospects dimmed by German slowdown.	Dec.	+ 4.7%	Nov.	+17.0%	5.25%	.0735	Interest rates rising.	**Austria**
	Widening current-account gap expected as export growth slows.	Jan.	+ 6.0%	Sept.	+13.2%	14.00%	.032785	Interest rates rise to support franc.	**Belgium**
	Strong pound keeps exports weak and current account in deficit.	Feb.	+16.1%	Oct.	+17.1%	17.00%	2.1780	Credit very tight, despite efforts to boost liquidity.	**Britain**
	No improvement in current-account deficit anticipated in 1980.	Dec.	+11.8%	Oct.	+10.1%	13.00%	.1688	Discount rate stands at a record 13%.	**Denmark**
	Trade gap of 624 million markkaa posted in January.	Dec.	+ 8.6%	Nov.	+17.4%	8.50%	.2605	Credit tightened with call for special deposits on Feb. 27.	**Finland**
	Higher oil bill pushes current account into deficit.	Feb.	+14.1%	Jan. '79	+10.9%	9.50%	.2275	Money conditions remain tight in support of franc.	**France**
	Current-account gap of DM 20 billion expected in 1980.	Feb.	+ 5.6%	Nov.	+12.6%	7.00%	.5272	Discount and Lombard rates raised to support the mark.	**Germany**
	Large current-account gap prompts heavy Euromarket borrowing.	Nov.	+22.7%	Aug.	+22.2%	19.00%	.0250	Credit conditions restrictive.	**Greece**
	Expected GDP slowdown should sustain 1979's $1.5-bn. current-account gap.	Nov.	+16.0%	Dec.	+27.5%	16.40%	1.9735	Private credit growth target a restrictive 13%.	**Ireland**
	Average monthly trade deficit for last three months tops $1 billion.	Feb.	+21.7%	Apr.	+14.8%	15.00%	.001137	Interest rates to rise further.	**Italy**
	Costly oil boosts 1979 current-account gap to 4.5 billion guilders.	Dec.	+ 4.8%	Oct.	+16.1%	9.50%	.4807	Rates ease somewhat as guilder strengthens in EMS.	**Netherlands**
	Jan. trade gap was kr. 64 billion, versus 267 million in Jan. 1979.	Jan.	+ 6.2%	Oct.	+16.1%	9.00%	.1965	Kroner strong on foreign-exchange markets.	**Norway**
	Revaluation likely to produce small current-account deficit in 1980.	Dec.	+22.4%	Oct.	+21.2%	17.00%	.0200	Credit restrictions ease only slightly.	**Portugal**
	Current-account gap of $1.5 billion forecast for 1980, due to costly oil.	Nov.	+15.4%	Nov.	+17.2%	8.00%	.0142	Monetary conditions remain restrictive.	**Spain**
	Trade gap of kr. 1.6 billion in Jan., versus kr. 200 million in Dec. 1979.	Dec.	+ 9.8%	Sept.	+22.8%	9.00%	.2270	Tight credit policy spurs capital inflow, boosting reserves.	**Sweden**
	Substantial reduction in current-account surplus expected this year.	Feb.	+ 4.1%	Nov.	+12.5%	3.00%	.5571	Domestic liquidity reduced further.	**Switzerland**
	Government may review foreign investment rules.	Feb.	+ 9.4%	Jan.	+24.3%	14.79%*	.8417	Central bank adopts floating discount-rate policy.	**Canada**
	Current-account gap narrows, but looks set to deteriorate.	Feb.	+14.2%	Jan.	+11.1%	13.00%**	—	High money market rates bolster dollar.	**United States**

* Floating at ¼% point above average yield on 91-day Canadian T-bills.

**16.00% for large banks that are regular users.

World Interest Rates

market rates of March 26, 1980; bond yields as of March 21, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00*	14.79	17.00	14.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	18.50 March 27	15.00	17.75	13.20	13.00	8.50	16.625	10.25	3.00	12.3125
Treasury Bills 91-day, Middle Rates	15.90	14.80	16.0625	17.50	n. a.	n. a.	14.90 95-day	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	15.125 finance paper 15% tax w/h	15.52	13.90 Certified	14.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.95	15.00 15% tax w/h	17.25	15.25 Certified	not traded	9.40	19.30	no market	0.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.37	13.90	14.40	12.65 20% tax w/h	13.31	9.85	14.95	11.26	5.09	9.43
Industrial Bonds prime, long-term, new and old issues, average yield	13.20 Aa Industrials	14.20	14.87	n. a.	14.74	9.89	14.79	12.35	6.16	7.32
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	15.75	18.00	18.75	14.85	10.75	20.00	13.50	4.50	9.25
Bank Time Deposits 3-month	17.125 Cert. of Dep.	14.95 Cert. of Dep.	17.8125	17.70	14.0625	9.50	10.75	11.375 large deposits	7.125 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	19.00	no market	18.875	no market	14.50	9.75	no market	11.25	7.1875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8417	2.1780	.032785	.2275	.5272	.001137	.4807	.5571	.004015
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.875 *P*	.25 *P*	1.375 *P*	4.00 *P*	9.00 *P*	.50 *D*	7.75 *P*	11.75 *P*	2.00 *P*

Eurodollar Deposits
(London, interbank, bid)
March 27

7-day	16.50
1-month	17.875
3-month	19.0625
6-month	18.00

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .19
U.S.-Canada Treasury Bills	−2.05
U.S.-Canada Finance Co. Paper	−3.75
Eurodollars-U.K. Local Auth. Deposits	+ .06

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.125
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	10.125

Gold Price
London afternoon fixing
507.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* 16.00% for large banks that are regular users.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.2 (Feb.)	9.4 (Feb.)	16.1 (Feb.)	14.1 (Feb.)	5.6 (Feb.)	21.7 (Feb.)	4.1 (Feb.)	7.6 (Feb.)
Industrial production*	0.7 (Feb.)	−0.4 (Jan.)	8.5 (Jan.)	1.5 (Jan.)	16.7 (Jan.)	7.9 (Jan.)	4.0 (Dec.)	9.7 (Jan.)
Trade balance† *(billions of local currency units)*	−$5.57 (Feb.)	C$.27 (Jan.)	−£.23 (Feb.)	−FF4.27 (Feb.)	DM.342 (Jan.)	−Lit.1,130 (Jan.)	−SF1.11 (Feb.)	−¥180 (Feb.)
Money supply (M_1)*	8.9 (Feb.)	6.7 (Feb.)	7.3 (Jan.)	10.9 (Nov.)	1.3 (Jan.)	25.5 (Nov.)	−2.4 (Nov.)	11.4 (Dec.)
Velocity of money (M_1)*	3.9 (Dec.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	+2,034 (Jan.)	+192 (Jan.)	+667 (Jan.)	+1,997 (Jan.)	−947 (Jan.)	+1,492 (Jan.)	−3,062 (Jan.)	+1,492 (Jan.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Ecuador Pursuing Steady Development

Ecuador is making sustained progress in the transformation of its economy. The country's gross domestic product reached $9 billion last year, a 5.3% real increase over 1978. And per capita income edged over $1,000—a significant achievement since the comparable figure was less than $300 just a decade ago.

Petroleum has provided the major thrust for Ecuador's economic development since 1972. Income from this source, combined with increased earnings from other commodity exports and the start-up of new industrial plants, has kept the economy's compounded average annual GDP growth rate at 7.5% during the 1970-79 period, well above the 5.5% average growth rate of the late 1960s. This faster growth has been accompanied by structural shifts in Ecuador's economy. In 1970, agriculture was the dominant economic sector, contributing 27% to real GDP. By 1980, however, manufacturing emerged as the major sector, accounting for 21% of GDP, while agriculture's share dropped below 20%. The petroleum industry, which is responsible for about half of total export earnings and a large share of government revenue, has increased its share of GDP from 1% in 1970 to 6% this year. Nonetheless, the country remains in the developing stages, evidenced by the dualism of economic activity (i.e., thriving modern and traditional sectors) and the large share of the labor force (over 50%) engaged in agriculture.

Aside from a drought-induced decline of 2.6% in agricultural output last year, all other sectors of the economy advanced fairly well. The utilities grew the strongest, more than 12%, while manufacturing posted real growth of over 10% for the third consecutive year. The brisk pace of economic activity has brought rising consumer incomes, and this, together with new entrants into the money economy, has contributed to increased consumer product sales.

Inflation moderated in 1979; price increases averaged 10.3%, compared with 13.3% in 1978. This was largely the result of the Government's cautious policy in the face of rising demand pressures. Both fiscal and monetary policies were somewhat restrictive in 1979, in order to stem strong upward price pressure. A cautious policy on wage increases, price controls, and subsidies on certain staples curbed the rate of price advances throughout the year.

The inflation outlook for 1980 is less encouraging. A doubling of the minimum wage from $80 to $160 per month became effective January 1, and it is expected to contribute heavily to the build-up of inflationary pressures. The impact on prices is already evident; the annualized inflation rate rose from 10% in December 1979 to 10.5% in January.

The huge OPEC oil price rises boosted this OPEC member's oil export earnings substantially in 1979. The merchandise trade surplus rose from $219 million in 1978 to nearly $300 million last year. With the average per-barrel price of oil about $25 last year, compared with $13 in 1978, exports of 44.7 million barrels earned revenue of slightly more than $1 billion in 1979. Contract and spot prices for Ecuadorean oil climbed as high as $40 per barrel in December 1979.

The impact of the near-doubling of oil export earnings in 1979 was sufficient to compensate for a 28% increase in imports and still produce an expanded trade surplus. This despite the fact that the volume of petroleum exports was slightly lower than in 1979, owing to a 15% increase in domestic consumption.

The improved trade balance, to be sure, was not due entirely to petroleum. Non-oil export receipts rose by almost 11%—admittedly, also mostly the result of world price increases rather than volume gains. Of the non-oil exports, the sharpest earnings increases were for bananas, wood, fish products, processed cocoa, instant coffee, household appliances, and manufactured goods.

The outlook through 1984

The near-term outlook will be determined to a great degree by the new National Development Plan (1980-84). The plan calls for greater emphasis on energy, agriculture, and social development. It also aims to apply increased resources to alleviating the constraints on the country's future economic performance: problems with public-sector revenue gathering, the rising service payments on the external debt, inflationary pressures, agricultural stagnation, the too-rapid increase in domestic gasoline consumption, and the need to increase the dwindling level of oil reserves.

The plan projects average annual GDP growth of 6.5% for 1980-84, with a 5.3% growth projection for 1980. (Per capita income is expected to rise by 20% over the period.) Total plan investment expenditures are targeted at almost $15 billion in real terms over the five-year period; of this total, 40% will come from the public sector and it is hoped that the remaining 60% will come from private sources. The plan anticipates that domestic savings will increase its financing share of investment costs from 81% to 86%, with foreign capital providing the remainder.

While the drafters of Ecuador's ambitious development plan were initially criticized for not collaborating with the private sector in its preparation, local businessmen have generally responded positively to its contents. And although some are concerned about the impact of increased government spending, particularly on inflation, most businessmen see new opportunities for the private sector to play a larger role in Ecuador's future development.

A. Blake Friscia

Indonesian Reserve Pile-Up Poses Problems

Indonesian authorities are currently faced with an enviable problem: how to allocate the huge increases in the domestic economy's real income stemming from surging foreign-exchange earnings. Foreign-exchange reserves (excluding gold) are estimated at at least $5 billion as of March 31, the end of the fiscal year, up about $2.1 billion for the year and sufficient to cover the cost of roughly five months of imports.

The remarkable increase in reserves can be attributed to a combination of three influences:

1. Higher prices for oil exports. Gross oil export earnings are estimated at $9.5 billion for fiscal 1979/80, up 31.5% from the previous year.
2. Sharp price rises for non-oil commodity exports, including timber, rubber, tin, and coffee. Non-oil export earnings were $5.5 billion in FY 1979/80, up more than 38% from the year before. In addition, natural gas production and exports continue to increase; LNG export earnings exceeded $400 million in FY 1979/80, about 78% higher than the prior year.
3. The positive impact of a 33.6% devaluation of the Indonesian rupiah in late-November 1978.

The rupiah's devaluation was motivated by the fear that oil earnings were beginning a long-term decline. With production currently averaging about 1.59 million barrels per day, down from the 1977 daily production peak of 1.68 million, and domestic consumption increasing by about 12% annually, a devalued currency was seen as countering the anticipated decline in oil export receipts by boosting non-oil exports and curbing imports. But because of the unusually large spurt in oil prices in 1979, oil earnings rose to new heights, thereby compounding the benefits of the devaluation and flooding the Indonesian central bank coffers with foreign exchange.

Oil earnings not yet fully reflected

Even so, the full effect on earnings of the overall increase in oil prices is only now beginning to be felt. The average price of Indonesian crude was about $13.50 per barrel at the end of 1978. The price increased by $8.20–a 61% jump–by mid-November 1979, and by another $8.60, or 40%, between November and February 1980 when the price per barrel reached $30.30. With a lag of several months before price rises are reflected in earnings, the balance of payments for fiscal 1979/80 ended March 31 will reflect little if any of the price increments realized after mid-November 1979. Thus, even assuming an average oil price of just $19 per barrel, a current-account surplus of about $1 billion is estimated for FY 1979/80, in contrast to a deficit of $1.2 billion in FY 1978/79. Assuming an average oil price of $33 per barrel for the new fiscal year, reserves are projected to exceed $8 billion by end-March 1981, with the current-account surplus likely to top $2 billion.

The inflationary consequences

The negative aspect of the liquidity build-up, however, is higher inflation. Up until now, the Indonesian Government has managed to contain the inflationary effects of the surge in foreign-exchange earnings. The monetary authorities have kept a tight rein on the fiscal budget and on credit expansion. These efforts were supplemented by substantial outflows of short-term capital attributable to post-devaluation nervousness in the financial markets, which helped to contain the money supply. The net result was money supply growth of about 35% in 1979, a full eleven percentage points higher than the growth rate of 1978, but much lower than it could have been. The increase in consumer prices in 1979 was 30%, most of which was tracable to the devaluation's direct impact on import prices. The inflation rate slowed during the latter months of 1979, however; it averaged less than 1% per month from September through December.

The outlook for inflation in fiscal 1980/81 is not encouraging. First, short-term capital outflows are expected to slow or even reverse, as confidence in the rupiah gains. Second, the run-up in government revenues has led to further pressure for increased expenditures, prompting the Government to announce a budget for fiscal 1980/81 with expenditures 52% higher than in the fiscal year just ended. The most inflationary budgetary item is a 50% increase in the salaries of all government employees. There are also indications that a large number of capital projects, some on the backburner since 1975, may be undertaken as various foreign ministries and agencies are eager to proceed. The consumer price index will also have to absorb another round of oil-product price increases. The budget calls for a 40% increase in domestic oil prices effective in April.

Thus, expectations are for another rise in inflationary pressures over the next few months, with an increase in the inflation rate that could total 20%-25% for the year. Still, real economic growth in 1980 is expected to rise by about 7.5%, up from the 6.8% growth rate of 1979. Although oil output will remain at about its recent level, production increases are expected in both agriculture and industry, spurred by higher export earnings and more expansive fiscal policy.

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CHASE

International Finance

Vol. XV, No. 8
April 14, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

B 1900-1
rcvd 4/14/80

Behind the Volatility of the Canadian Dollar

The Canadian dollar has gyrated wildly on foreign-exchange markets in recent weeks, moving from US$.861 on February 15 to a high of US$.875 on March 3 and subsequently dropping to US$.834 on April 1. These fluctuations—both the ups and downs—came in the wake of the Liberal Party victory on February 18, making it difficult to ascribe either the credit or the blame to the new government. What, then, is the explanation for the Canadian dollar's erratic behavior?

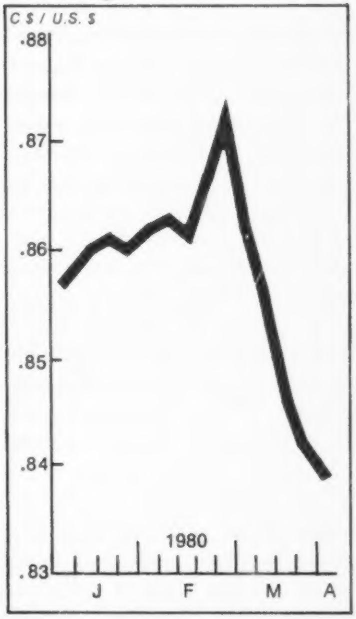
In a recent *International Finance* article on the links between U.S. and Canadian policy, Chase economists contended that "any effort on the part of the Canadian (monetary) authorities to diverge permanently from an interest-rate policy followed by the United States would lead not to mild or gradual depreciation or appreciation, but rather to sharp movements in the Canadian currency's value", owing to the substitutability phenomenon.

This perhaps best explains the Canadian dollar's recent volatility. Immediately after the election, the first large divergence in U.S. and Canadian interest rates emerged while the Canadian dollar was strengthening by some 1.3 U.S. cents. The foreign-exchange markets apparently ignored the absence of interest-rate adjustment, assuming it would follow when the new Canadian Government was firmly in power. Market observers were focusing on the good news out of Canada; i.e., that a majority government had been elected, trade appeared to be improving, and more discoveries of oil and gas were being made. This news boosted the Canadian dollar to highs not seen for 10 months. But then participants began to wonder about the Bank of Canada's commitment to maintaining a monetary policy similar to that of the United States. Once the markets began asking this question, the Canadian dollar began to sink. And once the markets came to believe in the real possibility of longer-run divergence between U.S. and Canadian monetary policy, the Canadian currency began to slide.

More recently, the Canadian dollar has stabilized somewhat. The major reason is the Bank of Canada's decision to allow the discount rate to float with the Treasury bill rate (and the implication that upward interest-rate movements would be politically palatable), as well as central bank intervention.

All in all, the experience with the Canadian dollar demonstrates that, as pointed out in the earlier *International Finance* article, "the (foreign-exchange) markets serve as a stern taskmaster, demanding in the long run that Canadian and U.S. policymakers follow similar paths, but forgiving short-run divergences." The short run now appears to be over.

Canadian/U.S. dollar exchange rate



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New U.K. budget underscores commitment to less government.

The new U.K. budget, unveiled on March 26, reveals the Thatcher Government's resolve to hold firmly to a policy of reducing the public-sector role and encouraging private enterprise. The Government plans a steady reduction in its expenditures, its budget deficit, and hence, in the rate of monetary growth, in the hopes of containing inflation. The authorities have also announced plans to treat social security benefits as taxable income and to reduce benefits payable to families of striking workers. Although the long-run impact of these policies may prove beneficial, the economy will encounter difficulties in the short run. The increased taxes on cigarettes and alcohol, for example, are expected to boost the rate of inflation, now 19.1%, to over 20% in the next few months. And tight money policies mean that there will be little opportunity in the near term to reduce interest rates from their current record levels. This in turn will work to dampen investment and add to strengthening recessionary forces, which already threaten the economy with a 2% GNP decline for 1980. Moreover, despite weakening activity, import demand is expected to continue strong, and the balance of payments is expected to remain in deficit to the tune of £200 million per month, despite increasing North Sea oil production.

Austrian interest rates raised to protect the schilling.

The Austrian monetary authorities have boosted the central bank discount and Lombard rates to their highest levels in 25 years—6.75% and 7.25%, respectively. The recent rate hikes—the second so far this year—were prompted by the need to protect the Austrian schilling, which is tied to the German mark, in the face of rising German interest rates and a widening current-account deficit. The current-account payments gap is forecast to rise from $2 billion in 1979 to more than $2.5 billion this year, the result of more costly oil imports. The country's net external borrowing is thus expected to climb from $870 million in 1979 to about $1.4 billion this year. Although debt service payments are estimated at some $500 million in 1980, annual exports of about $15 billion should keep the debt-service ratio comfortably low.

Greek austerity measures may cut real GNP growth sharply in 1980.

After four years of rapid growth, the Greek economy began overheating last year, just as oil prices were boosted. Real economic growth is provisionally estimated at 3.9% in 1979, and the rise in consumer prices averaged 19%, compared with consumer price inflation of 12.5% in 1978. The current-account deficit is estimated to have widened to about $2.3 billion after a $1.2-billion shortfall in 1978. Responding to these imbalances, the authorities took corrective actions in late 1979. Interest rates were raised, public spending plans were scaled back, a six-month 75% deposit scheme for non-essential imports was introduced, and an incomes policy aimed at holding wage increases to below 18% was imposed. While these measures should deflate the domestic economy, driving real economic growth to as low as 1.5%, another spurt in the net oil bill will probably help widen the current-account gap to about $2.5 billion in 1980. Inflation, however, should begin to ease late this year, and if present policies are maintained, the current-account deficit could improve in 1981. In the interim, Greece is expected to be a significant borrower on the international capital markets.

Korean economy adjusts to slower growth.

Korea's economy has entered a new adjustment period, shifting from a very rapid pace of expansion and accelerating inflation to a more steady growth path. Real GNP growth dropped to 7.1% in 1979 from an average of 11.7% in the three years preceding. The rate of inflation, however, worsened. Consumer prices increased by 21% in 1979, compared with 16.4% in the previous year. And in the external sector, the current-account deficit reached $3.9 billion, well above the $1.1-billion gap posted in 1978. This year, economic growth is expected to decelerate further to between 3% and 5%, while the current-account deficit may approach $5 billion. The inflation rate will likely remain over 20%, although the Government has taken steps to curb it. Fiscal and monetary restraints have been adopted, and the effects of high inflation will be moderated through flexible management of exchange and interest rates, (i.e., allowing the won's exchange value to decline and interest rates to rise). It is hoped that such policies will correct the distortions in the economy over time.

Brazilian authorities committed to price stabilization.

Brazilian inflation crept up to an annualized pace of 83.8% in March 1980, compared with a rate of 77% prevailing at the end of 1979. The upward price movement in the first quarter of 1980 was not unexpected, however. Farm support prices were raised in the hopes of stimulating output, while Brazil has had to absorb sharply higher oil import costs. The higher inflation levels have prompted the Government to underscore its commitment to utilizing a wide variety of price-stabilization policies. Most notably, the rate of credit creation is being held below the rate of price increase. And on the fiscal-policy front, public expenditures are being closely monitored and controlled. These efforts to restrain aggregate demand will have more impact on real economic growth than inflation, however, unless the rate of increase of wages can be brought under control.

UAE surplus rising steadily and dramatically.

The United Arab Emirates, an OPEC member that accounted for 5.9% of total OPEC crude oil output last year, registered a surplus on current account of an estimated $6½ billion in 1979, versus an estimated $2½ billion in 1978. This growth reflects the marked increase last year in the price of oil exported by the largest of the seven sheikdoms that comprise the federation, Abu Dhabi and Dubai. The official sales price of UAE oil rose 50% to a weighted average of $19.67 per barrel, bringing in estimated net oil revenues of about $12¼ billion. At the same time, imports of goods and net services, as well as transfer payments, rose to an estimated $7¾ billion. But non-oil earnings of an additional $2 billion, consisting mainly of income from foreign assets, brought the overall UAE surplus to $6½ billion. The UAE's 1980 current-account surplus is expected to be markedly higher. Official prices in 1980 will probably average at least $30 per barrel, generating net oil revenues of nearly $18¼ billion. And even allowing for a 24% increase in current-account outflows to $9½ billion, the resulting surplus is projected to be $12 billion, nearly double that of 1979.

Copper pricing back to supply and demand fundamentals.

Against the background of a U.S. slowdown and the increased likelihood of economic weakness in Europe and Japan, sharply rising interest rates and a collapse of precious metals prices have apparently wrung the speculative excesses out of the copper market. Since the first quarter of 1979, when copper supply was restricted by strikes in Canada and production and shipping problems in Zambia and Zaire, the supply/demand balance has been improving gradually; in fact, supply shortfalls disappeared well before year-end. As of February 1, 1980, for example, U.S. inventories were about 12% higher than in October 1979. U.S. producer prices of copper had risen from 80¢-90¢ per pound last June to a high of around $1.45 in mid-February, coinciding with the sharp run-up in inflation and precious metals prices. They are now back in the 90¢ range. Prices will likely remain weak over the next twelve months as worldwide copper demand continues to slacken. Since contracts for U.S. copper workers are set to expire on June 30, however, near-term prices could recover temporarily if a strike threat becomes more real or if international political tensions worsen.

The U.S. Economy

Commodities Lose Their Speculative Appeal

For all the turmoil they have experienced in recent months, the commodity markets may finally be signaling a bit of good news from the price front. Since mid-February, prices of a wide range of commodities have fallen dramatically. Over previous business cycles, commodity price shifts have often foreshadowed movements in the general price level. And now that prices of a number of commodities have been falling for two months, some economists are expressing cautious optimism that the frantic commodity speculation with which the year began has calmed down, and that inflationary expectations have, at least to some extent, eased.

Whether this will actually prove to be the case remains to be seen. It is difficult to generalize about a diverse group of markets subject to as many different influences as the commodity markets. One thing, however, seems certain: virtually all commodities—from pork bellies to platinum—have been affected by recent record-high interest rates. Clearly, high rates have significantly dampened speculative demand by making it more expensive to hold inventories and finance futures contracts. In addition, investors who had turned to the commodity markets in search of an inflation hedge can now find other less risky investments.

All these influences have contributed to downward price pressure in commodity markets. Commodity prices are now also reflecting the general slowing of the U.S. economy. Lumber and plywood prices, for example, have fallen 4½% since last fall as a result of the cutback in construction activity. Nonetheless, many commodity prices still remain above their year-ago levels. Precious metals prices, for instance, have eased substantially in recent weeks, but are still well above where they stood this time last year. And the same holds for some of the agricultural commodities, such as sugar, cotton, and wheat. The full impact on commodity prices of a possible U.S. economic slowdown coinciding with one in Europe and Japan is yet to be felt.

Many economists are doubtful about how much of that impact will actually be reflected in the key indexes of inflation. There are many other costs—energy, labor, and transportation, for example—that factor into the final prices of goods at later stages of production and distribution. Continued increases in the prices of these elements may well offset price declines in the commodity markets. However, if a global recession develops, sharply reduced worldwide demand for commodities may help ease overall inflationary pressures in the U.S. economy by precipitating further steep declines in commodity prices.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979*		BALANCE			
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Asia	**Bangladesh**	Real growth rose only 4% in 1979, owing to a disappointing agricultural performance.	June	+ 24%	8.9	$ 103	Feb.	449	+ 32%	3.6
	Burma	Four industrial nations grant $70 million in aid to modernize fishing industry.	Nov.	+105%	4.3	128	Jan.	212	+ 82%	7.6
	China, People's Republic	Grain output increased by 3.4% in 1979.	Oct.	+ 81%	515.0	510	June	3,538	+ 11%	3.0
	Hong Kong	Real economic growth expected to slow to 9% in 1980 from 11.5% in 1979.	Jan.	+ 37%	16.6	3,320	n.a.	—	—	—
	India	Sugar output for 1980/81 estimated at 7 million tons, compared with 4 million tons in 1979/80.	Dec.	— 3%	121.1	188	Dec.	7,432	+ 15%	9.9
	Indonesia	Real growth rate forecast to reach 7.5% in 1980/81, versus 5% last year.	June	+ 20%	43.4	289	Jan.	4,712	+ 57%	8.7
	Japan	Oil consumption in 1979 dropped 5% from previous year's level.	Feb.	+ 27%	948.0	8,243	Feb.	20,000	— 38%	2.2
	Korea	Manufacturing sector expanded 10.2% in 1979, versus 20% in 1978.	Jan.	+ 23%	61.1	1,624	Jan.	2,796	+ 2%	1.8
	Malaysia	Government plans substantial increase in public investment this year.	Sept.	+ 52%	17.3	1,310	Dec.	3,915	+ 21%	6.8
	Pakistan	Cotton output for 1979/80 estimated to reach 4.2 million bales, up 45% from 1978/79.	Nov.	+ 59%	20.9	265	Jan.	209	— 52%	0.6
	Philippines	Government projects 6% real GNP growth for 1980.	Jan.	+ 44%	29.1	512	Jan.	2,274	+ 30%	4.2
	Singapore	Industrial production climbed an annualized 11% in fourth-quarter 1979.	Dec.	+ 44%	8.9	3,708	Nov.	5,688	+ 10%	3.9
	Sri Lanka	Government plans to abolish all subsidies on consumer goods this year.	Oct.	+ 23%	3.1	206	Dec.	517	+ 30%	4.1
	Taiwan	Gross domestic capital formation increased 21.9% in 1979.	Feb.	+ 36%	27.6	1,623	Feb.	1,546	+ 7%	1.2
	Thailand	Rice production declines slightly to 17 million tons in 1979/80.	Nov.	+ 25%	26.0	565	Jan.	1,964	— 11%	3.4
Oceania	**Australia**	Government's large deficit declined slightly in first-half FY 1979/80.	Jan.	+ 38%	124.0	8,551	Jan.	1,711	— 17%	1.1
	New Zealand	Wool production will reach a record level of 343,000 tons this year.	Feb.	+ 33%	15.4	4,812	Jan.	464	— 26%	1.6
	Fiji	Real GDP growth estimated at 3% in 1979.	Sept.	+ 34%	0.9	145	Feb.	169	+ 28%	5.1

Loan Commitments Up Sharply

New figures reveal a substantial expansion of bank loan commitments in February. According to data just released by the Federal Reserve, commitments extended by the larger banks to nonfinancial business firms rose $9 billion in February, to a total volume of over $324 billion. This was the largest single monthly advance in the five years this data series has been maintained. And the rapid pace probably carried into March. From September through February, the total rise of commitments approximated a whopping $34 billion. These increases were mainly additions to unused commitments, rather than actual drawdowns of funds under commitments.

The surge in commitments has reflected a number of financing developments. First, overall funding requirements have expanded significantly in recent quarters—a typical pattern in the latter stages of a business cycle. Second, more recently the bond market's receptiveness to new debt offerings has eroded materially. Consequently, many firms have had to change their financing strategies. In this process, there has been substantial reliance on bank loans and commercial paper. Loan commitments from banks have been an adjunct to this financing strategy. Finally, a considerable amount of new commitment activity undoubtedly reflected concern by businesses over their future access to bank financing in the event of a government program of explicit credit curtailment.

The question that probably cannot be answered for some months (perhaps quarters) to come is how much recourse there will be to the higher volume of commitments. In recent years this usage factor (i.e., outstanding loans made under commitments as a percentage of the sum of such loans plus unused commitments) has ranged from a low somewhat above 37% (about where it is now) to a high of 46% in early 1975. Between 1976 and 1979, usage typically ranged between 38% and 39%. On average, in the months before the rapid commitment growth that began in late 1979, usage was running around 39%. Applied to the new February figures, such usage would raise actual loans outstanding by around $5 billion, or 4½%. Applying the unusually high usage of early 1975 would add $28 billion in loans outstanding.

While this arithmetic exercise could obviously be carried to even greater extremes, at least two major points seem clear. First, within a plausible range of usage percentages, drawdowns under existing commitments could increase outstanding loans by a sizeable amount. And such a pattern could develop within a relatively short time period—e.g., a few months. Second, such a spurt would entail heavy bank funding pressures in the money markets. Against this background, the emergence of signs of developing recession will by no means signal imminent relief from possible financing problems in the business sector.

PAYMENTS		MONEY AND BANKING							COUNTRIES
f IMF t, mil- dollars	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
		latest data	consumer prices	latest data	domestic credit	April 9, 1980			
22	Exports expected to rise 16% in FY 1979/80 to $700 million.	Dec.	+18%	Nov.	+20%	—	.0675	Credit restrictions remain in force.	**Bangladesh**
71	Rice export earnings rose 73% in 1979.	Dec.	+ 8%	n.a.	—	—	.1550	Improved reserves position boosts money supply growth.	**Burma**
0	U.S.-China trade nearly doubled in 1979.	n.a.	—	—	—	—	.6800	Bank of China borrows $300 million in Eurodollar market.	**China, People's Republic**
—	January trade deficit widened sharply, owing to export slump.	Jan.	+16%	Jan.	+37%	—	.1990	Prime rate reached 16% in March.	**Hong Kong**
0	Energy import bill will climb 30% to $6.25 billion in FY 1980/81.	Dec.	+12%	Nov.	+20%	9.00%	.1240	Large budget deficit boosts money supply growth.	**India**
0	Japan extends $1-billion loan for energy development.	Jan.	+28%	Oct.	+40%	—	.001635	Bank loans slowed in January.	**Indonesia**
0	Auto exports to U.S. rose 34% in February from year-earlier level.	Jan.	+ 7%	Dec.	+ 8%	9.00%	.003972	Government lifts restrictions on Eurodollar lending.	**Japan**
37	Textile export target for 1980 set at $4.9 billion.	Jan.	+24%	Jan.	+41%	15.00%	.0018	Tight monetary policy continues.	**Korea**
0	Export growth for 1980 projected at 23%.	Jan.	+ 6%	Dec.	+ 6%	—	.4380	Government restricts bankers' acceptance market.	**Malaysia**
36	Current-account deficit could reach $1.4 billion in FY 1979/80.	Jan.	+10%	Nov.	+24%	10.00%	.1020	Tight credit conditions persist.	**Pakistan**
67	Premium export tax to be imposed on precious metals exports.	Dec.	+24%	Dec.	+27%	4.00%	.1365	Central bank to liberalize domestic banking laws.	**Philippines**
0	January trade deficit was 45% larger than January 1979.	Jan.	+ 8%	Oct.	+24%	—	.4420	Prime rate climbed to 12% in March.	**Singapore**
08	Import and excise duties raised on certain consumer goods.	Nov.	+15%	Nov.	+42%	10.00%	.0675	Large budget deficit fuels money supply growth.	**Sri Lanka**
0	Exports in January-February rose 36% above year-earlier period.	Feb.	+18%	Jan.	+15%	14.00%	.0290	European banks now permitted to conduct business.	**Taiwan**
39	Rice export volume will drop 40% this year.	Dec.	+15%	Oct.	+23%	12.50%	.0510	Credit conditions remain restrictive.	**Thailand**
75	Wheat and flour exports continue to expand rapidly.	Dec.	+10%	Dec.	+15%	—	1.0850	Interest rates rise in response to those overseas.	**Australia**
36	Current-account gap nearly doubled in 1979.	Dec.	+17%	Dec.	+15%	13.00%	.9425	Loan advances rose 21.4% in January.	**New Zealand**
.5	Higher sugar prices will boost export earnings this year.	Jan.	+10%	Jan.	+24%	—	1.19	Domestic credit grew 30% in 1979.	**Fiji**

World Interest Rates

market rates of April 9, 1980; bond yields as of April 4, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 large banks 16.00	16.20	17.00*	14.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	19.25 April 10	16.00	17.25*	14.15	12.25	9.25	17.00	10.75	15.00	12.1875
Treasury Bills 91-day, Middle Rates	14.37	15.95	16.25*	17.50	n. a.	n. a.	14.60 82-day	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	16.875 finance paper 15% tax w/h	15.95*	13.90 Certified	13.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.95	16.75 15% tax w/h	17.625*	15.25 Certified	not traded	9.40	19.80	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.13	13.75	14.30	11.70 20% tax w/h	13.44	9.84*	14.87	11.10	5.11	9.96
Industrial Bonds prime, long-term, new and old issues, average yield	13.65 Aa Industrials	14.50	14.99	16.84	14.80	9.98*	14.83	12.39	6.04	7.56
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	17.50	18.50*	18.75	14.85	10.75	20.00	13.50	5.00	9.25
Bank Time Deposits 3-month	17.375 Cert. of Dep.	16.75 Cert. of Dep.	18.4375*	17.70	13.25	10.15	10.75	11.125 large deposits	6.75 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	19.3125	no market	18.25	no market	13.4375	9.9375	no market	11.1875	6.9375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8462	2.1800	.032970	.2290	.5302	.001138	.4833	.5610	.003972
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.375 *P*	.375 *P*	1.875 *P*	5.50 *P*	9.00 *P*	.625 *P*	7.875 *P*	12.25 *P*	4.875 *P*

Eurodollar Deposits
(London, interbank, bid)
April 10

7-day	18.375
1-month	18.75
3-month	18.8125
6-month	18.25

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n. a.
U.S.-Canada Treasury Bills	−3.14
U.S.-Canada Finance Co. Paper	−4.02
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.75
Over 7 yrs.	14.125
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	10.00

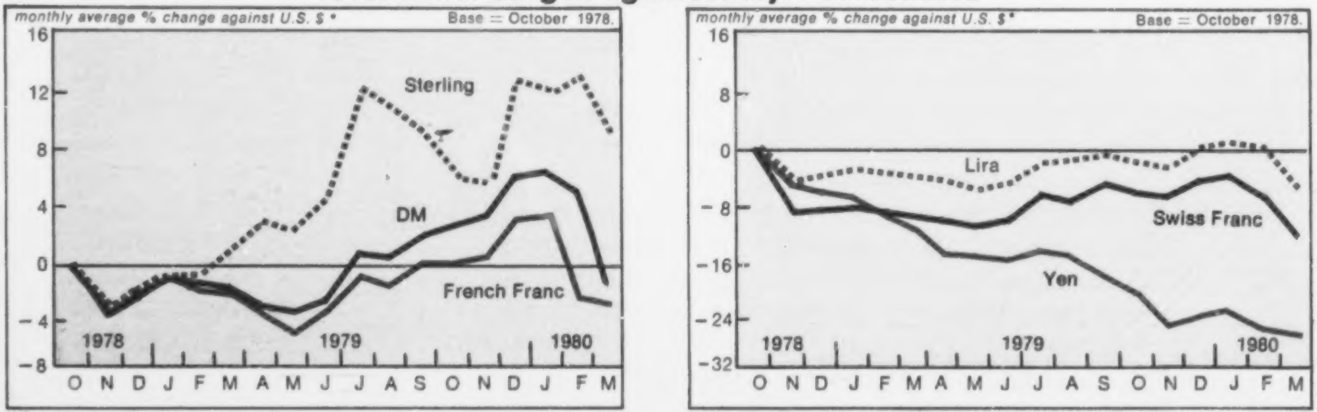
Gold Price
London
afternoon fixing

554.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Rates as of April 2; bond yields as of March 28.

U.S. dollar surges against major currencies



* U.S. dollars per foreign currency units

Hard Times for the Eximbank

The U.S. Export-Import Bank has come far in its effort to boost American exporters' competitive position in world markets with more attractive financing. But it is now faced with serious constraints that threaten its new style of aggressiveness—an aggressiveness that some bank critics claim is unwarranted and unsound.

The Export-Import Bank is the sole U.S. Government agency mandated to support U.S. exports through direct financing and guarantees. It has historically lagged behind its European and Japanese counterparts in the degree and scope of financing support offered because, unlike its main competitors, it must operate on a self-sustaining basis. But since 1977, the bank has been far more aggressive in meeting foreign competition by cutting interest rates, financing a greater share of export transactions (in partnership with private banks), and offering new forms of support. Specific initiatives have included:

□ maintaining the low interest-rate scale and cutting rates still further below scale to match competition in specific cases. The Eximbank's interest rates are on a sliding-scale basis, ranging from 7.75%-8.75%, depending upon maturity. The scale has not been raised, despite the sharp uptrend in both U.S. money market rates and Eximbank borrowing costs.

By January 1980, Eximbank-supported financing had clearly become more competitive, as the following table shows:

Approximate Interest Cost of Officially-Supported Long-Term Export Credits*

(percent per annum)

United States	9.50 (8.50)[1]
Canada	9.70
France	8.55
Germany	8.50
Italy	9.36
Japan	8.00
United Kingdom	8.55

*Includes fees, insurance, and private financing where required.

[1] For important transactions where competition is intense, Eximbank finance covers the entire credit.

In fiscal 1979 (ended September 30, 1979) about 40% of the value of all Eximbank direct credit authorizations carried below-scale rates. The average interest rate on new Eximbank direct credits in fiscal 1979 was approximately 8.2%, even though the average cost of funds to the bank had risen to 9.3% by the fourth quarter. The average interest rate on recent authorizations is currently between 8.2% and 8.3%, while the average cost of funds is now 10.7%, and the marginal cost, over 13%.

□ increasing the bank's direct loan participation to as high as 85% of contract values in many instances. In fiscal 1979, 30% of total Eximbank direct credit authorizations were for transactions where the Eximbank's financing share of individual contract values was 85%. The prime motivation behind the bank's increased share has been to reduce the blended interest rate by minimizing the role of much-higher-cost commercial bank finance.

□ extension of general purpose lines of credit. Last fiscal year, the Eximbank authorized lines in support of $714 million in exports.

□ local cost financing. The bank has the option to finance foreign local costs associated with the export of U.S. capital equipment and industrial plants that it is financing.

□ guarantees of foreign-currency-denominated loans made by commercial banks. The purpose of this new protection is to provide an alternative to dollar-denominated credits; foreign-currency credits may be perceived as more competitive in periods of U.S. dollar strength.

□ responding to foreign "mixed credit" offers. Eximbank has matched, on a number of occasions, the foreign practice of blending official export credits with aid to arrive at low-cost, long-term financing.

□ authorization to finance domestic sales. If American firms are offered foreign products on credit terms that violate the minimum standards set in the international arrangement on export credits, the Eximbank may help finance U.S. imports.

□ liberalization of insurance and guarantee protection, including increased political risk coverage, and certain insurance fee reductions.

In addition to these policy initiatives, the Eximbank's overall level of activity has increased dramatically. Direct credit authorizations—the key indicator of support for major, high-impact exports—totaled $3.7 billion in fiscal 1979, compared with $2.9 billion the year earlier and only $700 million in fiscal 1977. Total authorizations for *all* bank programs (including financing and guarantees) were $9.5 billion in fiscal 1979, up 29% from the $7.4 billion of fiscal 1978. Total bank authorizations in 1978 were, in turn, 32% higher than in 1977. In the first quarter of fiscal 1980 (October-December 1979), direct credit authorizations totaled over $1 billion, up 120% from first-quarter 1979, while authorizations for all bank programs were up 55% over the year-earlier quarter.

More recently, however, the Eximbank has encountered severe constraints on its expansive posture. The most onerous problem facing the Eximbank at the present time concerns its direct lending authority—for both fiscal years 1980 and 1981. The bank initially

Hard Times for the Eximbank *(continued from page 7)*

requested a ceiling of $4.1 billion for fiscal 1980. But Congress has failed to approve the request, effectively holding fiscal 1980 direct loan authorizations to their fiscal 1979 level of $3.75 billion—a sharp decline in real terms. And in February, a Senate subcommittee rejected the bank's proposed direct lending budget of $4.4 billion for fiscal 1981, demanding a more complete accounting of the bank's expenditure plans. It now appears that the ceiling for fiscal 1981 will lie somewhere between $4.1 and $4.3 billion. Such retrenching in the direct lending area has alarmed Eximbank officials who contend that cuts in this area have the potential for the most serious repercussions on the U.S. export performance, since this program supports the most exports per authorizations dollar.

As for the remainder of fiscal 1980 (ending September 30), the Eximbank's direct lending authority will have to be curtailed sharply. It is estimated that less than $500 million in loan authorization funds now remain. This may force the bank to close its lending window by late spring, unless the $3.75-billion lending limit is boosted before then. The likelihood of a budget crunch, however, has prompted the bank to adopt tighter direct lending guidelines. The Eximbank will generally offer interest rates of not less than 8.75%; it will attempt to limit its financing share of individual transactions to 65%; and it will restrict the volume and tighten the terms on aircraft loans (which accounted for 38% of all Eximbank direct loans in fiscal 1979).

As an inducement to U.S. exporters to participate in financing, however, the Eximbank is prepared to increase its financing share of individual deals by up to 10% if exporters will finance matching shares at the same 8.75%. (The goal is full 85% financing at the subsidized rate.) This appeal to the export community is reminiscent of a similar Eximbank appeal to commercial banks in early 1978 to provide fixed-rate export financing with Eximbank guarantees of a market rate of return. The latter proposal failed to generate much interest, but Eximbank officials appear more optimistic about exporters' willingness to respond to the bank's latest initiative.

Other limitations preventing the bank from providing flexible and competitive support include:

- time-consuming oversight by the Departments of Commerce, State, and Treasury, the Federal Reserve, and the Office of Management and Budget. Congress also influences Eximbank activity by setting annual authorization limits, and having the right of approval on transactions valued at over $100 million;
- human rights limitations that prohibit Eximbank from financing exports to such countries as Chile; and
- inability to boost worldwide interest-rate minimums specified in the international arrangement on export credits; these currently range from 7.5%-8.0%. Increasing these rates is especially critical in view of the bank's high cost of funds, but progress in negotiations remains elusive.

The relative importance of financing

It is difficult to say how all these limits and constraints will hurt the competitive position of U.S. exporters, since financing is only one aspect of export competitiveness. Other important influences include the wide range of government tax and legal restrictions that can inhibit U.S. businesses from competing abroad effectively. Responsibility also lies in the private sector; U.S. exporters must aggressively pursue export opportunities, with products that are competitive in terms of price, quality, and suitability to foreign tastes.

Moreover, an important justification for increased export competitiveness is to improve the U.S. trade balance. But in this regard, opponents of the Eximbank, and of export subsidization in general, argue that curbing imports is equally effective. And this can be accomplished by reducing domestic demand with less expansive fiscal and monetary policies, which could also help ease inflationary pressures. Opponents of an increased Eximbank role also argue that Eximbank funds are wasted on financing the exports of large corporations that do not really need the financial subsidy, while others worry about the effect of expanded and generous support on the bank's long-term financial condition.

Nevertheless, with heightened concern about employment and recession in various sectors of the economy—evidenced by the increased pressure for protectionism—U.S. exporters are making a strong case for the stimulus provided to exports, and to the economy, by increased Eximbank support. And perhaps in the short run, there is good justification for both greater operational autonomy and increased Eximbank funding (applied to a diversity of industries and markets)—if only to keep pace with our competitors abroad.

But U.S. Government and business leaders are realizing that a more comprehensive approach to the overall issue of U.S. competitiveness is needed for the long run. This must consist of a coordinated effort by both public and private sectors to foster increased productivity and competitiveness through a combination of tax and legal incentives for exporters and private bankers, stepped up research and development, competitive pricing, and aggressive marketing. To the extent that progress is made in these areas, the Eximbank's role could be reduced over time.

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CHASE

International Finance

Vol. XV, No. 9
April 28, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

4/29/80 B 1900-1

U.K. Holds Firm to Monetarism

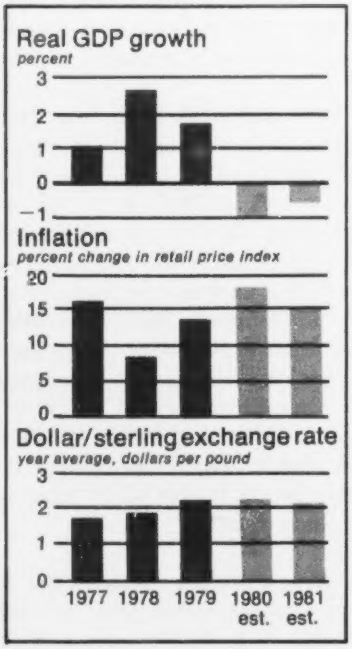
The Thatcher Government has underscored its commitment to monetarism, evidenced by the two highly restrictive budgets introduced since the Conservatives came to power in 1979. The commitment to monetarism is expressed both in the narrow sense of restricting money growth, and in the broader sense of reducing the role of the Government, encouraging individual initiative, and allowing market forces to operate more freely. The hope is that such a policy approach will bring down inflation and foster an increase in productive capacity matched by a larger rise in private demand—ultimately generating prosperity and full employment.

The British authorities plan to reduce steadily the volume of public expenditure and the rate of money growth over the coming years. While income taxes have already been cut, with the maximum rate down from 85% to 60%, social security benefits will be restricted. Such policies represent a major shift from those of previous governments. It thus remains an open question whether or not they will eventually succeed in changing the populace's economic thinking and improving the country's hitherto poor economic performance.

What is clear is that the next two years will be difficult ones. Output already began to slow in 1979, ending the year with a real GDP growth rate of only 1.7%, compared with 2.7% in 1978. And the combination of reduced government spending and high interest rates will lead to absolute declines in economic output in both 1980 and 1981. Earnings have been rising at an annual rate of some 19% over the last few months, and with retail prices also posting increases of nearly 20%, it seems doubtful that wage demands will be greatly moderated when the annual wage round commences in July. Since containing inflation is the Government's overriding objective, it is apparently determined to keep to its goal of holding annual money supply growth to no more than 11%. Corporate profits will therefore be severely squeezed, and unemployment is expected to rise rapidly.

One of the few near-term bright spots, however, is the pound's exchange rate. A generalized realization that Britain will become self-sufficient in oil during 1980, and a net exporter thereafter, has greatly increased investment demand for sterling. Capital inflows were $7.8 billion in 1979, which helped to raise U.K. reserves from $15.7 billion at the start of the year to $22.5 billion at year-end. Sterling has been strengthened further by a monetary policy that has pushed British interest rates well above those available in most other countries.

U.K. indicators



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French credit-tightening policy complicated by EMS obligations.

Signs of continued economic buoyancy are worrying French authorities about the build-up of inflationary pressures. Consumer price index hikes of 1.9% in January and 1.1% in February have now brought the index to 13.4% above its year-ago level. And latest indicators reveal a surge in monetary growth at the end of 1979. M_2 rose 1.6% in December, bringing the year-over-year increase to 14.2%. The target growth rate for 1980, by contrast, is 11%. Accordingly, new measures have been introduced to rein in credit growth, a policy consistent with Prime Minister Barre's commitment to a strong exchange-rate policy. Categories of lending previously exempt from controls have been progressively reincorporated. Beginning May 1, 50% of such lending for export credit and energy-saving purposes is to be subject to the credit-control system guidelines, as against only 30% just last fall. Home purchase credit will now be wholly included. Recent German mark weakness, however, has pushed the French franc to the top of the European Monetary System's currency band, posing a dilemma for French authorities. Domestic monetary policy is increasingly at variance with the need to keep the franc within its EMS intervention limits. Thus, commitment to the EMS may force the French to compromise on further credit tightening.

Finnish growth remains high, but inflation threatens.

Finland's economy is now slowing down, after posting 8% growth in 1979. Still, the country expects to remain one of the fastest growing OECD members, with GDP growth of about 4.5% projected for 1980. A major economic problem is the acceleration of inflation. The rate of price increase rose to 9% in January, after averaging 7.4% in 1979, and has made recent wage negotiations the most difficult in many years. The central bank has sought to moderate the inflationary impact of higher import prices by revaluing the Finnish markkaa, whose value, after the latest 2% revaluation of March 26, is some 4.6% above its year-ago level. But relatively high wage settlements and a balance-of-payments deterioration are complicating inflation-control efforts. During 1979, the current-account deficit was 1.1 billion markkaa, and the overall payments deficit was about 2.3 billion, following surpluses of 2.5 and 3.0 billion markkaa, respectively, in 1978. Moreover, the trade figures for the first two months of 1980–indicating a deficit of 1.1 billion markkaa, versus a surplus of 0.3 billion for the year-earlier period–suggest that a further deterioration in the balance of payments can be expected in 1980.

A rough year ahead for Spain's deteriorating economy.

The Spanish economy performed poorly in 1979, and is likely to deteriorate further in 1980. Faced with weak domestic demand and a slowdown in the world economy, economic growth fell from 3% in 1978 to about 1% in 1979, and the country is likely to see growth of no greater than 0.5% in 1980. As of the end of 1979, 1.33 million Spaniards were out of work–over 10% of the working population. And unemployment is projected to exceed 1.5 million in 1980 as the economy stagnates further. At the same time, the inflation outlook has deteriorated. Although the average rate for 1979 was down to 15.7% from 19.8% in 1978, rising fuel costs and the recent weakening of the peseta are expected to add to inflationary pressures throughout 1980. Rising fuel costs have also played havoc with the external accounts. Although a current-account surplus of some $1 billion was expected for 1979, latest Bank of Spain estimates indicate that higher oil prices pushed the actual account into a deficit of $800 million, which represents a deterioration of $2.5 billion from 1978. And a further rise in the oil bill is expected to increase the current-account gap to $2.5-$3.0 billion in 1980.

Malaysian economic growth continuing strong.

Malaysia posted real GNP growth of 8.5% in 1979, a healthy rise from the already strong 7.6% rate of 1978. Inflation-adjusted national income grew an even faster 15%, reflecting a strong improvement in terms of trade. Private-sector expenditures rose 11.4% in 1979, led by strong export earnings, high demand for residential and commercial buildings, and continued improvement in the investment climate. Public-sector expenditures also increased sharply, by 12.4%. The increased public spending is related to efforts to meet the socioeconomic targets of the third five-year Malaysian plan, which runs through 1980. On the external front, export earnings were up 12.1% in real terms last year, versus 7.9% in 1978. Despite an 18.3% rise in imports, spurred by strong domestic consumption and investment demand, the country's current-account surplus was pushed over $1 billion, compared with $115 million in 1978, thanks to a 14.5% improvement in terms of trade. Export growth is expected to slow significantly this year, in response to the worldwide economic downturn, but continued strength in the resource-rich domestic economy should be sufficient to sustain overall economic growth of 7% or better in 1980.

Mexican oil production targets boosted.

Aided by continuing increases in its oil discoveries and output, the Mexican Government has raised its oil production targets through 1982 by 10%. By the end of 1980, oil output should reach 2.25-2.50 million barrels per day (bpd)—the target previously set for 1982. The new target for 1982 is now 2.70 million bpd. The higher production rate will satisfy increased domestic needs as well as assure an export level of over one million bpd through 1982. Larger oil export volumes—combined with higher oil prices—will enhance the Mexican trade accounts considerably this year, and help reduce last year's $3.2-billion merchandise trade deficit. And even assuming a sustained rapid pace of import growth, the higher levels of petroleum export earnings anticipated should help bring about a trade surplus by 1981.

Iran striving to increase its economic independence.

The Iranian economy is in the midst of a major restructuring. Iranian authorities have launched the new Iranian year with budgeted expenditures about 10% lower than last year and 25% less than the pre-revolution level. (One-third of expenditures are allocated to development projects, the same proportion as last year.) Domestic economic policies are geared to reducing dependence on Western economies, particularly in the wake of the Carter Administration's new sanctions. Agricultural prices for producers have been raised to stimulate production and lower food imports, and a substantial increase in acreage planted has been reported. On the oil front, the country's petroleum minister has announced that oil output for the next 12 months will average 3 million barrels per day, only half the peak reached prior to the revolution, and one-half million barrels per day less than production levels over the last three months. At the same time, Iran has sought to boost its price further, to some $34.50 per barrel, but it has encountered resistance in view of the high level of world oil stocks. Meanwhile, further pressure has been placed on the United States' European allies to join the economic boycott of Iran. If the boycott is indeed widened, Iran's economy will probably suffer a number of further shortages, but the economic impact is not likely to be far reaching.

Bumper crop for cocoa will add to downward price pressures.

With continued favorable growing conditions and new plantings, world cocoa production is expected to reach a record 1.59 million metric tons in the 1979-80 growing season, some 7% higher than the 1978-79 crop. Coinciding as it does with a period of increasingly sluggish demand, a bumper crop this year will mean another surplus in the cocoa markets—the third in as many years—and further downward pressure on cocoa prices. With the expiration of the International Cocoa Agreement in March, ten nations, responsible for about 90% of the world's cocoa output, have formed an alliance with the aim of supporting prices at roughly their current level. Although cocoa bean prices have fallen nearly 50% from their mid-1977 peak, they are still high by historical standards and this is contributing to a steady erosion of cocoa consumption, leading chocolate manufacturers to increase their usage of cocoa substitutes and extenders and to shift production to non-chocolate confectionary items. Moreover, economic slowdowns in the major cocoa-consuming nations are likely to weaken demand still further. Thus, the world's cocoa producers may find it increasingly difficult to support prices over the coming months.

Interest Rates Take A Dive

Interest rates have plummeted during the last three weeks. In part this decline has been in response to information suggesting that the U.S. economy is a good deal weaker than was believed last month. Slower-than-expected money growth and indications of a possible lowering of the Federal Reserve's trading range for the Federal funds rate have also been major contributors to the rate declines. While the market appears to be expecting short-term rates to fall even further during the next few months, there is considerably less agreement on near-term prospects for long-term rates.

From early April to last week, 90-day certificate-of-deposit (CD) rates dropped about 400 basis points. The drop in six-month and 12-month CD rates over the same period was even more precipitous—about 450 basis points. As a result, the yield curve for the CD market is now significantly downward sloping, in contrast to its upward-sloping shape three weeks ago. For example, the secondary market rates on one-month, three-month, and six-month CDs on April 23 were 14.60%, 14.15%, and 13.65%, respectively, while on April 4 they were 17.65%, 18.25%, and 18.30%.

The current CD yield curve suggests that market participants expect short-term CD rates to fall in coming months. Otherwise, the expected return from purchasing shorter-term CDs and rolling them over at maturity would significantly exceed that from purchasing long-term CDs. For example, 90-day CD rates three months from now would have to be about 12¾% or less in order for such a rollover strategy to yield a lower return than that obtained from purchasing a six-month CD.

The interest rate futures markets also suggest a market expectation of further declines in short-term rates. Rates on both Treasury-bill futures contracts and commercial-paper futures contracts maturing from June 1980 on are well below current spot interest rates.

In the bond market, long-term rates also dropped sharply, with 20-year Aa utility rates falling about 125 basis points since early April. Here, however, there appears to be a wide range of views as to whether this rate decline will continue. On the one hand, the combination of the recessionary outlook and expectations of further declines in short-term rates suggests lower bond yields. On the other hand, the magnitude of the recent drop in bond rates may have already reflected these forces. Moreover, the recent market improvement has led a number of corporations to schedule new bond offerings—some of which had been deferred earlier. This potential increase in the supply of corporate bonds could offset any increase in investor demand. It may take some time before there will be indications of whether the bond market can accommodate any significant increase in new bond offerings at current or lower yields.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE O				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest date	reserves (less gold) in million $	12-month change	months of imports covered	us cr lions
Argentina	Inflation rate continues to decline as government pursues policy of slower devaluation.	Jan.	+ 9%	102.1	$3,825	Mar.	9,821	+133%	18.5	
Bahamas	Restraints placed on sale of Bahamian real estate to foreigners.	Sept.	+ 13%	1.0	4,000	Feb.	87	+ 9%	4.8	
Bolivia	Tax cuts introduced in effort to revive mining sector.	Nov.	+133%	4.7	930	Feb.	112	− 39%	1.6	
Brazil	Inflation ran at a high rate through March, but the economy now shows signs of cooling.	Feb.	+ 31%	209.1	1,760	Dec.	8,966	− 24%	5.5	
Chile	Government emphasizing need for profitability of state enterprises.	Dec.	+ 64%	19.0	1,710	Feb.	2,166	+ 68%	6.4	1
Colombia	Credit controls eased; economic activity continues at brisk pace.	Jan.	+ 14%	28.7	1,100	Feb.	4,015	+ 63%	14.3	
Costa Rica	Economic adjustment program implemented in connection with IMF standby loan.	Dec.	+ 27%	3.9	1,790	Jan.	103	− 49%	0.9	
Dominican Rep.	Economic development plan for 1980-82 includes expanded role for foreign investment.	Jan.	+ 66%	5.3	1,000	Feb.	186	+ 68%	1.7	1
Ecuador	New production of autos, trucks, and utility vehicles is underway.	Jan.	+ 73%	8.7	1,070	Feb.	805	+ 32%	5.0	
Guatemala	Minimum wage increase of 186% in agricultural sector causing concern, especially for coffee growers.	Dec.	+ 9%	7.2	1,060	Feb.	702	− 12%	6.1	
Guyana	Real economic growth fell 2% in 1979, the result of shortfalls in bauxite, sugar, and rice.	Dec.	− 3%	0.5	625	Nov.	15	− 80%	1.0	
Jamaica	Bauxite production levy lowered to boost output; election pushed up to August.	Sept.	− 3%	2.7	1,230	Jan.	126	+ 49%	1.6	3
Mexico	Oil output rate to be raised 10% above earlier plans; economic momentum strong.	Feb.	+ 73%	117.9	1,700	Nov.	1,927	+ 10%	1.9	1
Panama	Light assembly and processing industries adding to employment potential.	Nov.	+ 15%	2.7	1,420	Jan.	114	− 38%	4.6	
Paraguay	Inflation rate subsides in January, but is still above 30%.	Dec.	− 10%	3.7	1,225	Feb.	605	+ 30%	13.9	
Peru	Severe drought expected to reduce agricultural output substantially.	Dec.	+ 77%	12.1	700	Jan.	695	+143%	5.5	4
Uruguay	Output in industrial sector rose 8.5% in 1979, the highest rate in two decades.	Nov.	+ 19%	7.2	2,500	Dec.	381	+ 33%	6.0	
Venezuela	Salaries bill calling for generous pay increase recently passed.	Nov.	+ 53%	46.1	3,385	Jan.	6,816	+ 25%	6.9	

Recession Alone Won't Cure Inflation

Now that President Carter has enlisted fiscal and monetary restraint in the fight against inflation, some of his critics contend that the real foot-soldiers in the battle will be the growing ranks of the unemployed. A recession and higher unemployment are likely to result from the policies aimed at curbing inflation. Indeed, a recession may already be under way. But the depth of this recession—as well as the extent of any improvement in inflation—will depend in large part on two vital psychological elements: how firmly inflationary expectations are ingrained, and how credible the public perceives the Administration's policies to be.

Fiscal and monetary policies combine to set the overall level of demand in the economy, along with the public and private shares in total spending. But there are many other influences on productivity gains and real economic growth. Accordingly, restrictive policies could be consistent with many possible combinations of real growth and inflation. For the economy to grow at its potential rate in the face of restrictive policies, price and wage increases must moderate. But if expectations of future inflation are so deeply embedded that prices and wages resist such moderation, then the policies will result only in lower real growth and higher unemployment.

Inflation rates have fallen during and just after past business downturns, but the improvements have been short-lived. As unemployment rises in a recession, slackness in labor markets moderates wage demands. Slower wage gains, together with falling demand for these products, help to ease price hikes. The cyclical behavior of labor productivity reinforces this effect, since productivity usually improves during a recession, also easing pressure on prices.

Stop-and-go fiscal and monetary policies have accentuated the cyclical behavior of inflation in the last 15 years. The first effects of restrictive fiscal and monetary policies are on business activity, and only much later on inflation. Restrictiveness, generated by inflation fears, led to downturns in the economy in 1969 and 1974. But by the time these policies began to take their toll on inflation, the authorities shifted course and adopted stimulative policies to fight unemployment. The result was another surge of inflation.

Considering this past record, it is not surprising that Americans so far have been unwilling to take the Government's commitment to fight inflation very seriously, and have thus resisted lowering their expectations about future inflation. It appears that at least several years of consistent anti-inflation policy will be necessary to alter these expectations significantly. In the interim, unemployment may well climb higher than it is now. However, if the anti-inflation policies are maintained, even in the face of deepening recession, the long-run economic costs of lost output (and employment) will be far less than if the course is reversed again. The path will then be paved for more sustained real economic growth in the future.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				April 23, 1980			
of IMF t, mil- f dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
	Imports up 55% in January.	Mar.	+119%	Dec.	+206%	—	.00061	Domestic liquidity increases.	Argentina
	Non-oil exports show strong gain.	Jan.	+ 12%	Sept.	+ 5%	—	1.01	Prime rate raised from 9% to 11%.	Bahamas
	Multilateral bank loans of $100 mn. will help cover current-account gap.	Nov.	+ 20%	Nov.	+ 45%	—	.0520	Credit growth limited.	Bolivia
	Farm exports may aid the trade balance.	Mar.	+ 84%	Feb.	+ 74%	33.00%	.0220	Cruzeiro loans very limited.	Brazil
	Exchange rate indefinitely fixed at 39 pesos per U.S. dollar.	Feb.	+ 39%	Aug.	+ 48%	—	.0275	Private money supply expands slowly.	Chile
	Exchange-rate policy changes include faster devaluation pace.	Dec.	+ 26%	Jan.	— 26%	20.00%	.0260	Cash reserve rule of 100% removed on new deposits.	Colombia
	Trade gap was $650 million in 1979; Government allocates funds to spur exports.	Dec.	+ 13%	Dec.	+ 42%	8.00%	.1200	Interest rates lowered.	Costa Rica
	High sugar prices boost export earnings, but oil import bill is huge.	Dec.	+ 26%	Sept.	+ 9%	—	Par	Credit growth limited.	Dominican Rep.
	Petroleum exports show large increase.	Jan.	+ 11%	Nov.	+ 43%	8.00%	.0400	Domestic credit availability limited.	Ecuador
	Tourism down 25% in first quarter of 1980 from year-earlier level.	Dec.	+ 14%	Dec.	+ 25%	—	Par	Tight credit policy prevails.	Guatemala
	Consumption tax placed on imports.	Dec.	+ 16%	Dec.	+ 29%	10.50%	.4000	Private-sector credit increases.	Guyana
	International commercial banks agree to maintain existing payment terms.	Dec.	+ 18%	Dec.	+ 21%	11.00%	.5800	Bank liquidity scarce.	Jamaica
	Government rejects GATT entry.	Mar.	+ 23%	Dec.	+ 31%	4.50%	.0450	Domestic interest rates move higher.	Mexico
	Canal earnings up 9% in 1979.	Nov.	+ 10%	Dec.	+ 23%	—	Par	Credit growth is strong.	Panama
	Cotton exports decline.	Jan.	+ 34%	Dec.	+ 30%	—	.0080	Private credit growth below inflation rate.	Paraguay
	External sector continues to register remarkable growth.	Oct.	+ 64%	Sept.	+ 36%	29.50%	.0040	Domestic liquidity growing excessively.	Peru
	Government seeks to raise wool output by 15% over next five years.	Oct.	+ 73%	Oct.	+ 84%	—	.1190	Credit growth is high.	Uruguay
	First-quarter oil export volume down 15% from year-earlier level.	Dec.	+ 21%	Nov.	+ 4%	8.50%	.2335	Restrictive credit policy prevails.	Venezuela

World Interest Rates

market rates of April 23, 1980; bond yields as of April 18, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 large banks 16.00	15.96	17.00	14.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	16.50 April 24	17.00	16.75	16.70	12.875	9.00	17.00	10.25	7.00	12.375
Treasury Bills 91-day, Middle Rates	12.05	15.40	16.00	17.25	n. a.	n. a.	14.50 126-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	13.00 finance paper	15.50 finance paper 15% tax w/h	15.16	13.90 Certified	13.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.35	15.40 15% tax w/h	16.5625	15.25 Certified	not traded	9.40	18.40	no market	0.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.79	12.30	13.87	11.03 20% tax w/h	12.78	9.14	14.93	10.25	5.07	10.17
Industrial Bonds prime, long-term, new and old issues, average yield	11.90 Aa Industrials	12.875	14.83	14.54	14.50	9.20	14.70	11.43	5.99	7.89
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	17.25	18.00	18.75	14.85	10.75	20.00	13.00	5.50	9.25
Bank Time Deposits 3-month	14.375 Cert. of Dep.	15.40 Cert. of Dep.	17.25	17.00	12.9375	9.85	10.75	10.50 large deposits	7.00 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	16.4375	no market	17.625	no market	13.00	9.00	no market	10.25	6.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8455	2.2745	.03400	.2360	.5479	.001167	.4961	.5902	.004117
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.625 *P*	1.00 *D*	.625 *D*	3.125 *P*	6.875 *P*	1.125 *D*	6.00 *P*	9.375 *P*	2.75 *P*

Eurodollar Deposits
(London, interbank, bid)
April 24

7-day	16.6875
1-month	15.625
3-month	16.3125
6-month	15.125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.73
U.S.-Canada Treasury Bills	−3.20
U.S.-Canada Finance Co. Paper	−1.29
Eurodollars-U.K. Local Auth. Deposits	− .19

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.50
Over 7 yrs.	12.00
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	10.00

Gold Price
London
afternoon fixing

506.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.7 (Mar.)	9.4 (Feb.)	19.8 (Mar.)	13.4 (Feb.)	5.8 (Mar.)	21.8 (Feb.)	3.9 (Mar.)	7.2 (Mar.)
Industrial production*	−1.2 (Mar.)	4.1 (Feb.)	−1.4 (Feb.)	3.8 (Feb.)	7.7 (Feb.)	12.0 (Feb.)	4.0 (Dec.)	12.3 (Feb.)
Trade balance† *(billions of local currency units)*	−$5.57 (Feb.)	C$.82 (Feb.)	−£.18 (Mar.)	−FF5.85 (Mar.)	DM.460 (Feb.)	−Lit.1,260 (Feb.)	−SF1.23 (Mar.)	−¥9.9 (Mar.)
Money supply (M_1)*	7.8 (Mar.)	12.9 (Mar.)	5.9 (Mar.)	9.5 (Jan.)	−1.1 (Feb.)	25.5 (Nov.)	−11.1 (Jan.)	7.0 (Feb.)
Velocity of money (M_1)*	3.9 (Dec.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	4.1 (Dec.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	−123 (Feb.)	+415 (Feb.)	+24 (Feb.)	+545 (Feb.)	−2,552 (Feb.)	−655 (Feb.)	+293 (Feb.)	−655 (Feb.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Foreign Impact on Monetary Policy

Central bankers throughout the world share the common goals of promoting production, fighting inflation, and maintaining a healthy exchange rate through the use of monetary policy. More recently, the monetary authorities in several countries, notably the United States, have moved to an "aggregate" or "monetary-base" target policy to achieve these goals. By doing so, these central bankers implicitly acknowledge the existence of a stable relationship between money, prices, interest rates, and income.

The experience of the various central bankers has been quite different. Although Germany has continually experienced higher-than-targeted money growth, it has contained inflation fairly well. The United States, however, has had lower money growth targets than Germany in recent years, but has continually overshot these targets and suffered high and accelerating rates of inflation. Two lessons emerge from the collective experience of the Western world's monetary authorities: (1) It is more difficult to meet targets than to set them, and (2) the inflationary consequences of meeting or not meeting targets are uncertain, at least in the near term.

The explanation for the generalized failure to meet monetary targets and control inflation and exchange rates may be found in the monetary authorities' interpretation of the "money demand function," which specifies the determinants of aggregate demand for a particular country's currency. Most national monetary authorities look at the *domestic* demand for money in setting targets and designing policy. However, under present world money market conditions, a more comprehensive money demand function is needed—one that incorporates both *domestic* and *foreign*, or *external*, demand for an individual nation's currency. One need only point to the world reserve currency role of the U.S. dollar and the increasing reserve role of the German mark to underscore the importance of foreign demand for the stronger currencies.

Any analysis of money demand functions must begin with the reasons for holding money. Generally, money is demanded for three purposes: transactions, precautionary, and speculative. The most important variable to consider when analyzing the demand for money, however, is the speculative motivation, since it is the most volatile and least understood. In most statistical models of money demand, the interest rate is used to "explain" much of the speculative motivation. Thus, when central bankers use interest rates as an instrument to implement a monetary policy, they are assuming some degree of predictable responsiveness of money demand to interest-rate changes. However, if one acknowledges both domestic and foreign demand for money, two questions arise: How does the responsiveness of foreign demand for a currency differ from domestic demand, and how are exchange-rate expectations factored in? Monetary policies are very likely to affect domestic and foreign demand for a currency in different ways. It is therefore important that the monetary authorities recognize the elements impinging on speculative demand—which is a key variable in any distinction between domestic and foreign demand for money—before they target the monetary aggregates. Moreover, they must consider the exchange-rate implications of any policy decision.

One indicator of the external demand for a currency is the *velocity* of money, i.e., the speed with which a nation's money stock is turned over each year. The velocity of the U.S. dollar, once considered to be on a downward long-run trend, is now rising sharply, while velocity of the German and certain other currencies has been either falling dramatically or remaining relatively flat. There are many influences on velocity. But the sharp contrasts in velocity movements between the United States, on one hand, and Germany and Switzerland on the other, may be the result of the continued erosion of the foreign demand for U.S. dollars and the increasing roles of the mark and Swiss franc in world financial markets. Reduced demand for dollars, for example, fosters increased velocity as foreigners turn over their dollar holdings more quickly, rather than retain them and risk further depreciation.

It is therefore crucial that central bankers understand why and to what degree foreign demand affects their ability to implement policy, since they must be able to forecast inflation, income, and exchange-rate movements accurately. For example, a central bank may estimate that a growth target of 5% is appropriate for certain monetary aggregates. But if external demand for its country's currency is falling rapidly, velocity will rise and the inflationary impact of the policy supporting this target may be much greater than expected. Indeed, if the 5% target were set assuming no decline in external demand, the policy might increase the inflation rate more than anticipated, damage the nation's currency on foreign-exchange markets (possibly accelerating the fall in demand further), and undermine the credibility of announced policy.

Thus, the monetary authorities must now begin to consider the foreign component of money demand—its magnitude and stability—when setting policy. Both domestic and external demand must be considered when setting policy targets and, more important, when implementing the policies supporting the targets. The time has clearly come for new ground rules to keep pace with the growing internationalization of currencies.

D. Sykes Wilford

A Turning Point for Euroloan Spreads

Interest-rate spreads on Euromarket loans are now on an upward trend, apparently having hit their trough in the final quarter of 1979. Such spreads, or mark-ups, over the London Interbank Offer Rate (LIBOR) had fallen to ⅜% and ½% for prime borrowers and to below 1% for certain relatively less creditworthy borrowers.

Determining the accurate price of Euromarket loans is a very difficult task. While the spread over LIBOR is a very visible and important price feature, it is only part of the story. Other price elements include front-end fees, grace periods, and repayment terms. Thus, as spreads begin to widen, fees, grace periods, and maturities should change as well. Indeed, there is already some evidence suggesting that front-end fees are rising rapidly. Moreover, grace periods are disappearing, and maturities are shortening. But while changes in these areas may moderate increases in spreads in the short run, they are not expected to temper the upward movement of spreads over the longer term.

All of the relevant Euroloan price factors continue to adust to significant changes in the international capital environment. Perhaps the most critical development has been the sharp rise in lending risks stemming from OPEC oil pricing. OPEC pricing suggests an aggregate surplus of over $100 billion this year, which alters dramatically the financing requirements of many borrowers dependent on Euromarket funds. Although not all borrowers will be affected by higher oil prices —loans to certain multinational borrowers, for example, are no less risky than in 1977 or 1978—several countries are finding themselves saddled with large (and perhaps not so temporary) current-account deficits that have hurt their implicit risk ratings. Certain country borrowers may thus face sharply higher spreads as they seek selective reschedulings of their debts.

Aside from increases in risk, decreased bank competition is also exerting upward pressure on spreads. The most notable development in this regard was the Japanese Government's directive to its banks last year to halt temporarily their Eurolending activity.

Another important influence on Euroloan spreads is the absolute level of U.S. dollar interest rates. The level of U.S. rates is expected to decline in the second half of the year as the long-awaited U.S. recession begins to affect credit demands and reduce inflation. With the level of short-term interest rates heading down, spreads can rise more easily. This is because borrowers anticipate lower interest-rate costs associated with Euroloans, owing to expectations of declines in LIBOR. Lenders may thus seize the opportunity to boost spreads, since the average spread increase is small relative to the LIBOR declines expected.

Nonetheless, an accurate assessment of just how high spreads will climb is difficult to provide. New lending volume has been weak, as national borrowers are drawing down reserves and utilizing short-term trade credits. However, borrower reliance on short-term credit will diminish as capacity constraints are reached.

Furthermore, the role of the multilateral lending institutions remains unclear. The World Bank, for example, has now become involved in "program" as opposed to "project" financing, which mandates it to assist selected countries with current-account problems by financing imports that enhance export earnings. Such lending is clearly a step toward balance-of-payments assistance.

In sum, the headline-breaking news of record Euroloan spreads has not yet come. But evidence indicates that the downturn in Euroloan spreads has definitely ended, and that the direction of change is unambiguously up for many Euromarket borrowers.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	IQ/79	IIQ/79	IIIQ/79	IVQ/79	1978	1979	1980
Gross Size (Claims)	883.3	946.6	1,041.5	1,070.0	892.7	1,070.0	1,340.0
Net Size (Claims)	550.0	585.0	635.0	655.0	535.0	655.0	820.0
Liabilities to Private Nonbanks	145.0	155.0	165.0	170.0	140.0	140.0	210.0
Claims on Private Nonbanks	285.0	295.0	310.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	226.5	243.8	260.8	273.4	222.7	273.4	330.0
Liabilities to Private Nonbank Foreigners	55.0	57.6	61.9	62.3	54.8	62.3	72.0
Total Claims on Foreigners	291.2	306.1	330.7	338.6	293.0	338.6	420.0
Claims on Foreign Public Borrowers	35.7	36.1	39.6	41.3	33.9	41.3	55.0
Claims on Foreign Private Nonbank Borrowers	103.5	107.6	113.1	118.6	104.2	118.6	140.0

Note: Gross and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

CHASE

International Finance

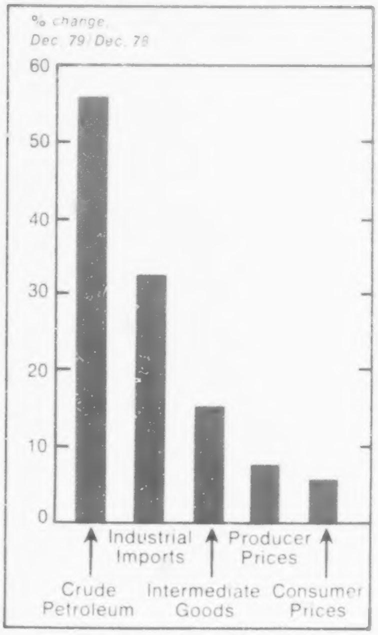
Vol. XV, No. 10
May 12, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

German Inflation Headed Upward

The German cost-of-living index for April was only 5.7% higher than its year-earlier level, but is set to rise sharply over the coming months. Indeed, the growth of consumer prices may reach 7.5% or higher in 1980.

Several forces are converging to boost German inflation rates. First, the impact of the OPEC price shock in 1979, coupled with the general inflation in dollar prices, has not yet worked through the economic system. Second, Bundesbank monetary actions taken in 1979 were not sufficient to stem the upsurge of inflation in 1980. And third, the rapid pace of economic activity in late 1979 and early 1980 has exerted upward pressure on prices and on the velocity of the money supply.


German price rises in selected sectors

Germany's consumer price index rose less than 6% in 1979, although fuel prices increased by more than 50% and imported goods prices climbed over 25%. The failure of higher prices for imported raw materials and intermediate products to feed through into consumer prices, however, is only a temporary phenomenon. With many input costs increasing at a rate faster than 1% per month, similar increases for consumer prices are not far off. Expectations that the German mark would appreciate against the dollar and reduce fuel and other dollar-based import prices have not been validated. Thus, with no benefits deriving from the foreign-exchange market, the pass-through from import prices to domestic consumer prices will very likely accelerate.

In response to these inflationary pressures, the Bundesbank has moved slowly in boosting short-term rates. The rate adjustment process was begun in March 1979, but at that date rates were unusually low because of the 1977-78 fall of the dollar. Thus, the initial rate increases represented a return to "normal" levels, as opposed to real anti-inflationary moves. Even the interest-rate hike at the end of April (see German highlight on page 2) was viewed as an insufficient monetary policy response. The foreign-exchange markets initially reacted by bidding up the dollar against the mark, even in the face of declining U.S. interest rates.

Finally, the strength of the German economy has helped boost both prices as well as the velocity of the money stock. Velocity was actually declining in 1978 and early 1979 at an annual rate of over 5%. It is now rising at a 4% annual pace. Such a dramatic velocity shift means that any equally dramatic declines in money growth rates have little meaning, and do not constitute an actual tightening of monetary policy.

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Canadian GNP growth likely to be flat in 1980.

The Canadian economy appears to be following the United States into a recession. Canada's economy, as the United States', has seen recent declines in housing starts, new manufacturing orders, imports, and retail sales. Other indicators, such as industrial production and unemployment, however, have remained stable. Moreover, Canada has also managed to keep its inflation rate at less than 10% through March, and there is a high probability that it will not come anywhere near the U.S. average of 15% anticipated for 1980. Unemployment has also held steady at 7.4% since the start of the year, but the rate is likely to rise slightly as demand weakens. On balance, the signals suggest a real GNP growth rate for 1980 of either zero or slightly above, as compared with the −0.5% or worse real GNP forecast for the United States.

German central bank rates move higher, but second half may see rate declines.

The German Bundesbank's recent interest-rate tightening took some market observers by surprise. The discount rate was boosted from 7.0% to 7.5% and the Lombard rate, from 8.5% to 9.5%. At the same time, minimum reserve requirements were lowered by 8% and rediscount quotas were raised by 3 billion marks. The net effect was a total injection of approximately 8 billion marks into the banking system. The latest measures are intended to narrow the widening gap that had developed between domestic money market rates, which were over 9%, and the discount and Lombard rates. Another ostensible objective is to counter the recent acceleration in the central bank money stock, whose annualized growth rate over the past three months has risen slightly above the Bundesbank's 5%-8% target range. If the recent rise observed in German bank lending was caused by unintended inventory buildups in the face of weakening consumer demand, the second half of 1980 will likely see a decline in German money market rates, particularly in light of the declining trend in U.S. dollar interest rates. However, rising inflation may temper any very rapid downward rate adjustment.

Italian economic growth continues strong, but policy restraint is likely.

The Italian economy ended 1979 on a strong note. Real GDP in the fourth quarter rose at a seasonally adjusted annual rate of 15.6%, and growth for the year as a whole was revised up to 5%–the fastest economic growth rate of the major European countries. Moreover, the economy apparently continued to grow strong in early 1980, as industrial production in February was some 12% above its year-earlier level. The strong year-end and early 1980 economic growth ensure an average GDP growth rate of at least 3.3% in 1980, well above the earlier official forecast of 1.5%. Inflation and a large and growing trade deficit, however, continue to cause concern, and a tightening of monetary and fiscal policies appears likely. Thus, Italy will not remain immune to the economic growth slowdown that will affect the rest of Europe in the latter part of 1980.

High inflation threatens Swedish growth prospects.

The Swedish Government's 1980/81 budget proposals, first submitted in January, have recently been revised in light of higher-than-expected inflation. The rate of growth of consumer prices has now been boosted to an annualized pace of 13.6%. The higher inflation will increase the budget deficit to some 11% of GNP this year, and the prospect of a widening deficit thereafter has led to plans to slash the growth of future government spending in order to reduce the deficit to 7% of GNP by 1985. Inflation is clearly a major concern of the Swedish authorities. The Government imposed a six-week price freeze effective March 26, stating that the freeze could be extended through 1980 if the unions accept moderate wage settlements. But negotiations are proving exceptionally difficult this year, with unions seeking 11.4% increases and employers offering 4%. Strikes in the public sector have already occurred, and roughly 85% of manufacturing capacity has been halted by strikes and lockouts. If average wage settlements exceed 7.5%—the income growth rate that the Government is assuming in its balance-of-payments and growth forecasts—Sweden's economic growth prospects will be worsened significantly. A 10% settlement, for example, could raise the Swedish current-account deficit to some 18 billion kronor in 1980—as against the Government's expectation of a 16.6-billion kronor shortfall—and to about 20 billion kronor in 1981.

Japanese trade balance will shift into deficit in 1980.

Japan's export performance so far this year has recovered from its poor showing in 1979. The value of exports in the first quarter was up 17.2% over the comparable 1979 quarter, with substantial gains in shipments of automobiles, optical equipment, and heavy machinery. The increase in exports, however, cannot simply be attributed to the 17% depreciation of the yen against the dollar over the course of 1979 and the first quarter of 1980, as export prices in dollar terms declined less than 2% in first-quarter 1980. And because of the already narrow export profit margins and the sharp rise in oil and other commodity import prices, it is unlikely that dollar prices of Japanese exports will decline any further in the future. On the demand side, the recession in the United States and possible import restrictions abroad are likely to slow considerably the rate of increase in demand for Japanese exports toward year-end. Therefore, while exports should continue to grow in 1980, their rate of growth is likely to moderate. And with rising imports, Japan's overall trade balance is expected to shift from a surplus of more than $2 billion in 1979 into a small deficit in 1980.

New South African budget limits state role while spurring private sector.

South Africa's $16-billion budget for fiscal 1980/81 is aimed at stimulating private sector growth, while reducing the public sector's role in the economy. The new budget limits the growth in total state expenditure to 14%, equal to the current inflation rate. Defense, government salaries, housing, and education are the only sectors to receive real increases in allocations. Incentives to the private sector include structural tax reforms, and abolition of the import surcharge and of loan levies. On balance, government revenues are budgeted to increase by 20% to $13.2 billion, owing largely to an estimated near-tripling of gold mining earnings. It is hoped that the resulting budget deficit of $2.8 billion—32% higher than in fiscal 1979/80—will spur higher private consumption and investment, and thereby generate more rapid economic growth. Provisions made for financing the deficit without resort to money creation ensure against its adding to South African inflationary pressures.

India sees need for greater export orientation.

India's traditional neglect of its external sector is showing signs of reversing. Export orientation has taken a long-standing back seat to a policy of import substitution, largely because of the country's vast domestic market and its desire for economic self-reliance. But India's deteriorating balance of payments has apparently triggered some degree of policy reorientation. The trade balance is expected to post a deficit of $2.7 billion in fiscal 1979/80, double the $1.3-billion gap of fiscal 1978/79 and nearly 10 times the $276-million deficit of FY 1977/78. While exports increased 16% on an average annual basis from fiscal 1971 to 1978, they grew only 3.6% in fiscal 1978/79 and only 5% in FY 1979/80. Imports, however, rose 20% in fiscal 1978/79 and 21% in fiscal 1979/80. Indian authorities would like to double India's now-small share of world exports, which would entail annual export growth of 18%. Such a goal may be attained over the next five years, with the appropriate stimuli. In this regard, the authorities have introduced some incentives to spur capital goods exports in the form of increased government financing support. And there is some consideration being given to the establishment of an export credit bank that would finance and actively promote Indian exports.

Money Supply Plummets

The seasonally adjusted money supply in the March/April period registered its sharpest two-month decline in the last three decades. From February to April, M_{1a} declined at a seasonally adjusted annual rate of about 8%; the corresponding drop in M_{1b} was about 5½%. In the past, sharp declines in money growth have often occurred either during or just prior to major slowdowns in economic activity. At times, however, forces unrelated to aggregate demand have caused the relationship between money growth and total spending to break down temporarily. While such forces may be partly responsible for the recent dropoff in the money supply, it appears that the slower money growth numbers are more indicative of the combination of a tight monetary policy and a weakening economy.

One hypothesis—unrelated to aggregate demand—as to why the seasonally adjusted money supply has fallen stems from the 1980 revisions of the seasonal factors. These revisions caused seasonally adjusted annual M_{1a} growth in the March/April period to be about 2½% lower than it would otherwise have been. This, however, does not explain most of the decline. In fact, March/April M_{1a} growth adjusted using current seasonals was *stronger* than trend in the previous three years.

The increased speed with which the U.S. Internal Revenue Service processed income tax payments this April has also been suggested as a "non-demand" reason for some of the slowdown in April money growth. Most of these payments are made by checks drawn against demand deposits—the largest component of M_{1a}—and the longer the processing time, the longer these checking balances are counted in the money supply. Tax payments were processed much more quickly this year than in the previous three years. However, this would only tend to depress the money supply in the latter half of April, and thus would not have contributed to the earlier weakness in money growth.

Still others speculate that the high interest rates in March and April led moneyholders to switch some of their money balances into highly-liquid interest-bearing alternatives. However, net assets in the most widely mentioned of these alternatives, money-market mutual fund shares, increased in March and April by only $232 million and $154 million, respectively—the smallest monthly increases in more than two years.

In the final analysis, it appears that the recent drop in money growth supports the view that the current economic slowdown is proving to be sharper than previously thought. It also suggests that the Federal Reserve's credit-tightening actions have been highly effective.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE				
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use c credi llons o
Africa	**Algeria**	Future LNG expansion program being reassessed.	Dec.	+ 49%	19.3*	$ 1,075	Mar.	3,044	+ 63%	4.9	
	Egypt	Increases announced in prices paid by the Government for some farm products.	Dec.	+121%	18.6*	484	Dec.	529	+ 64%	1.8	2
	Ivory Coast	Agriculture's share of expenditures in amended investment budget boosted to 30%.	Sept.	+ 48%	7.6	1,440	Jan.	52	− 88%	0.3	
	Kenya	GDP growth rate in 1980 unlikely to rise from last year's 3.5%.	Oct.	+ 26%	5.5	370	Mar.	573	+ 56%	4.1	1
	Libya	Domestic production of ammonia and phosphate fertilizers being studied.	Dec.	+ 93%	1.8*	6,635	Mar.	7,960	+116%	13.3	
	Madagascar	Production of most export and domestic crops continues to decline.	June	+ 24%	2.0	240	Aug.	63	− 30%	1.8	
	Mauritius	Reductions in food subsidies fuel accelerating inflation.	Mar. '79	+ 18%	0.8	872	Mar.	43	+ 51%	1.4	
	Morocco	World Bank loan of $112 million granted for oil exploration and highway project.	Sept.	+ 22%	12.8	678	Feb.	407	− 30%	1.3	1
	Nigeria	New budget favors housing, agriculture, and education; defense allocations cut.	Feb.	+ 56%	41.4	520	Mar.	6,520	+204%	6.5	
	South Africa	Budgetary tax concessions should boost sales of semi-durables and durables.	Dec.	+ 48%	57.3**	2,070	Mar.	649	− 12%	0.9	
	Tanzania	Import shortages interfere with industrial production; transport problems curb agricultural output.	Apr. '79	+ 15%	4.3	263	Nov.	78	− 29%	0.8	1
	Tunisia	Joint venture set up with Kuwait to produce phosphate fertilizers in Tunisia.	Dec.	− 40%	5.9	966	Mar.	540	+ 41%	2.8	
	Uganda	Budget gap of $100 million likely in 1979/80, despite tax and customs duty increases.	Dec.	+ 19%	8.4	650	Aug.	135	+ 40%	3.4	
	Zambia	Copper production in 1980 to increase 5%-10% over 1979 level.	Dec.	+ 62%	3.2**	573	Feb.	78	+ 53%	1.0	4
Middle East	**Iran**	Budgeted expenditure for current fiscal year down about 10% from year earlier.	Dec.	+ 54%	76.4*	2,227	Dec.	15,208	+ 30%	23.5	
	Kuwait	Issuance of new work permits fell 43% in 1979.	Mar.	+ 11%	13.9***	12,278	Mar.	2,660†	+ 11%	7.0	
	Saudi Arabia	Several agreements signed for petrochemical projects.	Dec.	+ 68%	54.5***	8,400	Mar.	18,112†	− 7%	8.5	
	United Arab Emirates	Budgeted federal outlays set at $4.3 billion for 1980, up 64% from last year.	Dec.	+ 84%	13.8	19,435	Mar.	10,086†	+ 30%	2.4	

*1977 **1979 ***FY 1977/78 †Excluding state reser

Wages Set to Rise Sharply

The unemployment rate's climb to 7.0% in April from 6.2% a month earlier was the first time in more than two years that the rate moved outside of the 6% range. But despite what appears to be a weakening demand for labor, wage gains are not expected to moderate. In fact, they may well accelerate, reflecting persisting inflationary pressure in the economy.

Although the softness in the labor markets has been concentrated in only a few sectors to date, its impact is great. Construction employment dropped 350,000 in the last three months as high interest rates and reduced mortgage availability have slashed the level of housing starts. And the auto industry has laid off over 200,000 as the combination of tight consumer credit, declining real after-tax income, and inability to produce the small, fuel-efficient cars that the public wants has cut domestic sales dramatically. Such employment declines, which are expected to continue, are especially damaging to the economy because they hit high-wage industries. Accordingly, the impact on personal income and spending is more than proportional to the unemployment numbers. Furthermore, data on the distribution of unemployment suggest that it is primarily single-earner households that are suffering the income losses. As these households reduce their spending, layoffs will occur in other industries, such as household furnishings, appliances, and apparel.

Despite the spreading layoffs, however, wage gains for the larger unions are likely to move into the double-digit range. The average wage increase in 1979 was 8.8%, following three years of gains of about 8% per year. In new contracts without cost-of-living adjustments (COLAs), or escalator clauses, first-year settlements averaged 8% in 1978, just over 9% in 1979, and about 11% in the first three months of 1980. But the sharper gains show up in labor contracts with escalator clauses. In such settlements, first-year adjustments averaged nearly 7% in 1978 and about 6% in 1979 and so far in 1980. The COLA clauses in these contracts, however, spurred by higher inflation, boosted effective 1979 wage gains to more than 10%. And the recent step-up in the rate of price increases will lift such inflation-linked wage gains still higher in 1980.

Contracts incorporating COLA clauses currently cover 63% of the workers in the larger unions. Moreover, revisions of COLA clauses to ensure improved protection against inflation continue to be a major item on labor's bargaining list. Last year, COLA clauses compensated for about 50% of the increase in consumer prices, a percentage that is expected to rise this year in view of the increased scope and effectiveness of COLA clauses.

On balance, despite the deteriorating employment outlook, 1980 is very likely to see average wage gains for employed workers well into the double-digit range. Only a steeper-than-anticipated recession and more immediate and dramatic relief on the inflation front will moderate the high-wage outlook.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
MF nil- ollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	May 7, 1980		current monetary conditions	
	LNG exports to U.S. halted, owing to dispute over price hikes.	Dec. '78	+ 17%	Sept.	+ 28%	—	.2650	Euroloan of $100 million for TransMed pipeline signed.	**Algeria**
	Oil prices lowered from $40 to $34 per barrel for second quarter.	Dec.	+ 10%	Dec.	+ 23%	10.00%	1.45	Interest rates raised one percentage point.	**Egypt**
	Overall payments deficit was $143 million in 1979, after three years of surplus.	Dec.	+ 18%	Sept.	+ 27%	8.00%	.004830	Declining foreign assets restricts money supply growth.	**Ivory Coast**
	Sugar Rehabilitation Scheme will produce exportable surplus in 1980.	Nov.	+ 8%	Dec.	+ 14%	—	.1415	Credit restraint continues.	**Kenya**
	Oil output was 2.1 million bpd in Jan.-Feb., down 1.8% from year earlier.	n.a.	—	—	—	5.00%	3.41	Credit generally available.	**Libya**
	Targeted import limit for 1980 unlikely to close trade gap.	Jan.	+ 17%	Sept.	+ 48%	n.a.	.0049	Development banks no longer expanding credit.	**Madagascar**
	December cyclones estimated to have caused some 20% sugar crop loss.	Dec.	+ 39%	Feb.	+ 27%	10.50%	.1350	Selective credit relaxation for sugar sector.	**Mauritius**
	Phosphate rock export prices rising.	Mar. '79	+ 10%	Jan.	+ 12%	4.50%	.2650	Money supply growing more slowly.	**Morocco**
	Raw material and spare parts imports exempt from preshipment inspection.	July	+ 10%	July	+ 14%	5.00%	1.84	Government seeking $35-million, eight-year Euroloan.	**Nigeria**
	Non-gold mineral exports of $4.3 billion expected in 1980, up about 28%.	Feb.	+ 14%	Dec.	+ 16%	7.00%	1.2680	Forward dollar discount raised from 2.5% to 12%.	**South Africa**
	Small foreign exchange allocations to industry trigger use of supplier credits.	June	+ 12%	n.a.	—	—	.1250	Agricultural credit being emphasized.	**Tanzania**
	Oil export revenue increasing.	Jan.	+ 11%	Jan.	+ 10%	5.75%	2.72	Credit to private sector growing slowly.	**Tunisia**
	Aid inflow likely to ensure 80% import increase.	n.a.	—	June	+ 35%	—	n.a.	New currency may restore control over money supply.	**Uganda**
	Zimbabwe settlement should reduce military spending and import costs.	Dec.	+ 16%	Dec.	+ 8%	—	1.3225	Commercial finance more available.	**Zambia**
	Oil exports reported down to about 1.3-1.5 million barrels per day.	Nov.	+ 9%	June	+ 33%	9.00%	n.a.	Credit generally available.	**Iran**
	Oil output averaged 1.95 million bpd in Jan.-Feb., down 16% from year earlier.	Oct.	+ 7%	Jan.	+ 40%‡	—	3.71	Kuwait Fund lends $14 million to Niger and Oman.	**Kuwait**
	Propane prices raised $25 per ton April 1; butane lowered $5 per ton.	Dec.	+ 2%	Jan.	+ 87%‡	—	.3015	Claims on private sector rising steadily.	**Saudi Arabia**
	Abu Dhabi oil output was 1.4 million bpd in Jan.-Feb., down 5% from year ago.	n.a.	—	Jan.	+ 6%‡	—	.2700	Currency Board receives $267 million for real estate loans.	**United Arab Emirates**

‡Private sector only

World Interest Rates

market rates of May 7, 1980; bond yields as of May 2, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	15.40	17.00	14.00	9.50	7.50	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	10.50 May 8	18.00	17.25	17.00	12.50	10.50	17.00	11.125	8.00	12.50
Treasury Bills 91-day, Middle Rates	9.07	13.95	15.8125	16.75	13.52 one-year	n. a.	14.625 84-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	9.75 finance paper	14.65 finance paper 15% tax w/h	14.71	13.90 Certified	12.87 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	9.50	14.65 15% tax w/h	16.25	15.25 Certified	not traded	9.90	18.40	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.26	11.95	13.67	12.09 20% tax w/h	12.89	9.03	15.00	10.04	4.87	9.40
Industrial Bonds prime, long-term, new and old issues, average yield	11.05 Aa Industrials	12.125	14.65	13.90	14.37	9.05	14.83	11.16	5.62	7.75
Bank Short-Term Rate to Best Borrowers (prime rate)	17.00	16.25	18.00	18.75	14.50	11.50	20.00	12.50	5.50	9.25
Bank Time Deposits 3-month	9.50 Cert. of Dep.	14.65 Cert. of Dep.	16.5625	16.00	12.9375	10.15	10.75	11.25 large deposits	6.625 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	11.375	no market	16.875	no market	13.25	9.50	no market	11.25	6.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8450	2.2870	.03490	.2390	.5615	.001189	.5070	.6075	.004335
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.70 *D*	5.75 *D*	.40 *P*	1.65 *D*	1.55 *P*	4.65 *D*	.10 *P*	5.20 *P*	.95 *D*

Eurodollar Deposits
(London, interbank, bid)
May 8

7-day	**10.00**
1-month	**11.0625**
3-month	**11.25**
6-month	**11.25**

International Arbitrage
(3-month, hedged) ***+ in favor of U.S. dollars***

U.S.-U.K. Treasury Bills	**− .78**
U.S.-Canada Treasury Bills	**−1.53**
U.S.-Canada Finance Co. Paper	**−2.00**
Eurodollars-U.K. Local Auth. Deposits	**− .06**

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**11.25**
Over 7 yrs.	**11.625**
DM Bonds	
7 yrs. and under	**9.00**
Over 7 yrs.	**9.00**

Gold Price

London
afternoon fixing

510.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Hungarian Economic Indicators

(percent annual growth rates)

	1975	1976	1977	1978	1979	Plan 1980	Forecast 1980
National Income Produced	6.1	3.0	7.8	4.5	1.8	3.3*	2.5
Industrial Production	4.6	4.6	6.6	5.2	2.8	3.8*	3.5
Agricultural Production	3.7	−2.7	10.3	2.6	0	5.3*	2.5
Crops	4.7	−7.1	12.0	1.5	−2.5	10.5*	4.0
Livestock	2.5	2.7	8.4	3.5	2.0	0	1.0
Capital Investment	13.7	1.4	13.0	4.0	3.0	−4.5*	−3.0
Domestic Trade	5.4	1.4	6.2	3.4	1.7	n.a.	2.5
Cost of Living	3.8	5.0	3.9	4.6	8.9	3.7	7.5
Total Exports (forints)	11.2	3.1	16.5	0.9	16.7	6.0	6.0
Total Imports (forints)	20.6	−3.1	16.2	12.6	2.7	3.0	4.0

Data: *Statistical Handbook CMEA*, 1976-79
Magyar Statisztikai Evkönyv, 1978

*Midpoints of Plan ranges.

Hungary Experiments With Creative Reform

The rapid growth experienced by the Hungarian economy in 1977-78 has ended, but the consequences linger. The earlier boom, caused by soaring investment and excellent harvests, has left behind an external debt of over $6 billion and structural imbalances in the domestic economy. These problems, and the Government's response to them, contributed to slower economic growth in 1979 and are likely to restrain growth for several more years. Real national income grew by only 1.8% in 1979, compared with an average annual rate of 5.3% during 1975-78. While growth is expected to edge up to 2½% in 1980, much of the advance will be concentrated in the export sector, with the expectation of a decline in investment and limited growth in consumption.

A lackluster domestic economy

Most domestic economic indicators pointed downward in 1979. Industrial production growth, for example, slowed to 2.8% from 5.2% in 1978. Largely responsible for the slowdown was a 1½% decline in the industrial labor force triggered by budgetary and credit restrictions on state enterprises. Another influence was the general slowdown in investment growth to a rate of about 3%. Industrial production has been virtually flat since mid-1979, and in the first quarter of 1980 it was only 1% above first-quarter 1979.

Agricultural performance was even less favorable in 1979. A 2% rise in animal-products output was offset by a 2½% decline in crop production, leaving overall production essentially unchanged. The drop was most severe in wheat production, where output fell to 3.7 million metric tons in 1979, down 35% from 1978. A favorable corn harvest boosted total grain output to 12 million metric tons—a level still 11% below 1978. With no increase planned for animal production, total agricultural exports will decline in 1980.

Domestic demand is expected to remain weak. Indeed, total domestic spending on consumption and capital accumulation actually declined last year, with real growth concentrated in net exports. Following annual increases of 4% in 1977 and 1978, it is estimated that real household income fell by 1%-1½% last year, and the Government's annual plan calls for only limited recovery in 1980.

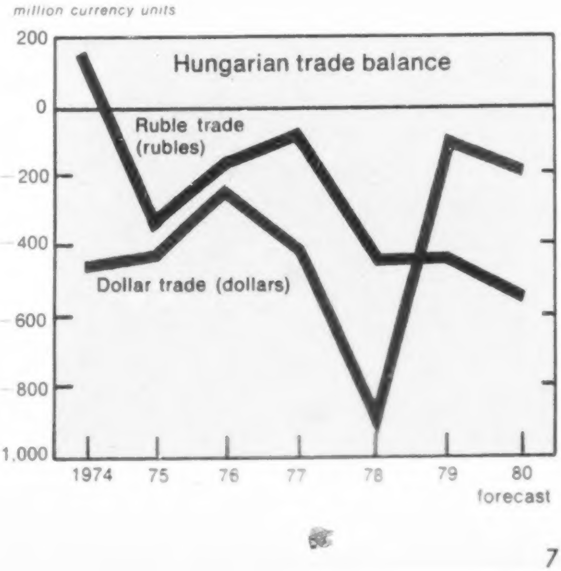
Adjustments in the external sector

The capital investment boom was largely responsible for the deterioration in Hungary's balance of payments in 1977 and 1978. The trade deficit in convertible currency (including trade with the West, developing countries, and some transactions with Socialist countries) rose from $418 million in 1977 to $926 million in 1978. The hard-currency deficit narrowed to $91 million in 1979, however, as exports increased by more than 30% while imports grew only 6%. Part of the improvement came from a reduction in Hungary's trade deficit with the industrialized countries to $700 million. Given an approximate balance in trade with developing countries, Hungary apparently achieved a large surplus in its convertible currency trade with Socialist countries (especially the Soviet Union). And in view of Hungary's overall trade deficit with the USSR, the Soviet Union was presumably willing to extend (nonconvertible) ruble credits to finance its exports to Hungary while paying (convertible) dollars for some imports. For 1980, the expectation is that the hard-currency deficit will widen to $200 million.

Hungary's trade deficit with the USSR in 1979 totaled 327.5 million rubles, after posting a surplus of 33.5 million rubles in 1978. The fastest growing component of Soviet-Hungarian trade is the convertible component, where highly marketable supplemental Soviet crude oil is exchanged for similarly marketable Hungarian beef exports and manufactured products. The Soviet-Hungarian trade agreement for 1980 projects a 500-million-ruble deficit for Hungary, with deliveries of 7.5 million tons of Soviet crude oil and 3.8 billion cubic meters of Soviet gas.

Price policy given pivotal role in reform

Hungarian authorities acknowledged their country's mounting economic problems in 1979 by introducing a comprehensive set of restrictive, but highly innovative, policies. The major problems acknowledged were the inefficiency of industrial enterprises, the irrationality of domestic prices, soaring energy consumption, and a deteriorating balance of payments.



Hungary Experiments With Creative Reform

(continued from page 7)

To address these difficulties, Hungary's leadership has granted a greater role to price policy than any other Socialist country aside from Yugoslavia. Consumer prices were raised repeatedly during 1978 and 1979, and the cost of living rose about 18% over the course of these two years. The most comprehensive set of price increases was announced in July 1979, when prices of food, energy, and various services were boosted. This was then followed, in April 1980, by an additional increase of 20%-30% in gasoline prices. While modest income supplements were provided for certain low-income groups, they were far from sufficient to cushion the higher cost of living for the broader population.

Prices paid by enterprises were also lifted sharply, as subsidies were reduced or eliminated. Economists defended these actions by arguing that the resulting liquidity squeeze would promote long-run enterprise efficiency by curbing expansions by high-cost producers, controlling discretionary investment, and reducing energy and raw material consumption.

The price reform policy was consolidated in January 1980. Hungarian producer prices were raised to world levels, but more significantly, a mechanism was established for future price adjustment. Domestic prices for raw materials will henceforth be determined by Western market prices, although prices for fuels and electric power will continue to be fixed by central authority. World market prices are to be the standard for domestic industrial prices covering 75% of current production. The major objective of the new price policy is to promote economic efficiency of state enterprises in the 1980s, encourage the adoption of efficient technologies, and guide investment to the most profitable activities. This price-adjustment mechanism was selected rather than allowing import competition to influence the domestic market directly. The latter alternative was ruled out because of the disruption it would threaten for many enterprises with monopoly positions. Moreover, the trade unions and Party officials opposed it because of the unemployment consequences associated with foreign competition.

The authorities have also made significant adjustments in foreign-exchange policy, guided by the long-term goal of a unified, convertible currency. At the beginning of 1979, the forint's exchange rates were modified and exchange regulations for visitors were tightened. The tourist exchange rate was raised from 50% to 75% of the commercial rate to encourage extended visits by Western tourists, while tighter restrictions were imposed on visitors' currency transactions.

External financing critical to development

External financing has played a critical role in Hungarian economic development in the 1970s. The country has been a regular user of the Euromarket, relying only minimally on official and supplier credits. After raising nearly $1 billion in Euromarket syndicated loans in 1979, the National Bank of Hungary has just signed another $250 million loan from Western banks. This latest loan, the first in 1980, is significant in several respects. First, it indicates that Western banks remain interested in lending to Eastern Europe in the post-Afghanistan atmosphere. Second, the loan signifies a tightening of terms in Euromarket lending—albeit one that is a more general phenomenon and not specific to Eastern Europe. The length of the new loan's repayment term is seven years, shorter than previous loans. And the principal price option, a spread of ¾% over the London Interbank Offer Rate, is higher than those charged on last year's syndications. With the large improvement in Hungary's current account during 1979, a spokesman for the National Bank has indicated that total borrowing will decline to $500-$600 million in 1980.

Hungary's net debt to the West reached $5½ billion by end-1978, and during the first nine months of 1979 net debt to Western banks rose by another $708 million. With the sharp rise in indebtedness to Western banks, Hungary has now begun to consider sources of official credit in the West. The country has utilized the U.S. Commodity Credit Corporation for certain agricultural purchases, and has obtained a $10-million line of credit from the U.S. Export-Import Bank.

A new Politburo in place

In view of Hungary's ambitious economic reforms and the austerity implied for consumers over the next five years, a critical question is whether the new strategy will receive adequate political support. On this front, the prospects appear favorable. The 12th Congress of the Hungarian Socialist Workers' Party, held in mid-March, established a political consensus to implement these policies over the next five years. Several senior party officials were dismissed from their posts, and a new Politburo has emerged. It is probably the youngest and best-trained political leadership in Eastern Europe, and its firm loyalty to First Secretary Janos Kadar promises a united and determined approach to the solution of Hungary's economic problems in the 1980s.

Donald W. Green

CHASE

International Finance

Vol. XV, No. 11
May 26, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

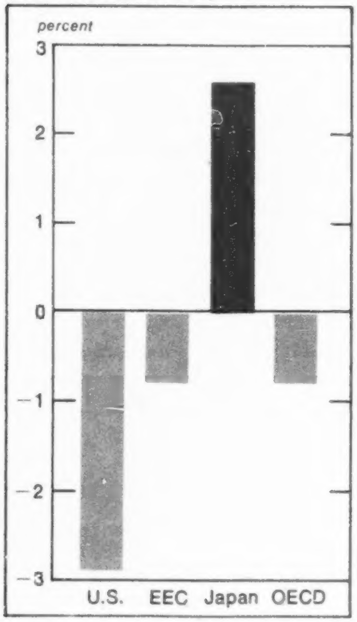
5/27/80 B1900-1 U

Growth Outlook for The World Economy

The outlook for the growth of the world economy over the next twelve months is increasingly bleak. Although output has held up to the oil price shocks better than anticipated, current evidence suggests that the industrialized world is entering a period of economic downturn that will be relatively synchronized across national economies and too severe to warrant the description "growth slowdown." There is no general agreement as to what is meant by the term "world recession," but the likely magnitude and degree of synchronization of the impending downturn are such that this term would seem to apply even though the downturn's dimensions are unlikely to match those of the global recession of 1974-75.

As was the case in 1974-75, the magnitude of the downturn will be more severe in the United States than elsewhere. The U.S. economy is now in a recession that may continue into the early months of 1981, with a peak-to-trough decline that appears likely to fall in the 3.5%-4.0% range. Since the oil price shocks hit the European economies during a period of relatively robust growth, the indirect deflationary effects of the OPEC price actions have been slower to develop there than in the United States. Nonetheless, the European economies are now slowing markedly, and growth in the EEC could turn negative as early as this summer. The dimensions of the downturn in Europe are less clear than in the United States, but, on current evidence, a peak-to-trough decline in EEC output of approximately 1.0%-1.5% would seem difficult to avoid. Of the major industrialized economies, only Japan appears unlikely to move into a technical recession. Barring a major disruption in Middle Eastern oil supplies, Japan should enjoy positive economic growth this year, albeit at a sharply reduced rate.

Selected real GNP growth estimates
(IVQ 1979 to IVQ 1980)



The common characteristic across economies of the impending downturn is a real decline in demand for consumption goods resulting from the sustained erosion of real personal disposable income. This common feature is also a major source of potential forecasting error, for consumer behavior is notoriously unstable. If consumers in Europe and Japan cling to past living standards as stubbornly as U.S. consumers have over the past year, the extent of synchronization of the downturn would be weakened and its peak-to-trough dimensions reduced. Much more likely, however, is a pattern of rising personal savings abroad. If this develops, a downturn of the proportions of a world recession would appear virtually inevitable.

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Swiss monetary policy remains tight, but relaxation is possible later in the year.

The Swiss economy looks set to enjoy sustained real growth into the second half of 1980, with surveys revealing a high degree of business confidence. GDP growth is expected to exceed 1.5% this year, compared with 0.7% in 1979. The strong growth, however, threatens to give Switzerland its first current-account deficit in 15 years. While inflation remains the chief concern, the outlook for prices has improved. Consumer prices rose at an annual rate of only 3.7% in the first four months of the year, although some acceleration is anticipated in the short run because of higher mortgage rates and a weak exchange rate in the first quarter. Accordingly, monetary policy will continue restrictive, and further substantial declines in interest rates are not expected before midyear. Thereafter, policy will be determined by the exchange-rate outlook, which is an encouraging one. The franc has already recovered by some 5% from less than 1.04 German marks earlier in the year. And if the dollar encounters additional downward pressure, some relaxation of German monetary policy will provide the scope for further appreciation of the Swiss franc and a rapid unwinding of interest rates later in the year.

Denmark's new economic package lacks punch.

An economic package presented to the Danish Parliament by Prime Minister Joergensen on May 7 has proven highly controversial. The package constitutes yet another attack on Denmark's chronic balance-of-payments deficit. It entails a further increase in the value-added tax (boosting it to 22%), together with additional taxes on electricity, fuel, oil, and gasoline, in addition to cuts in public spending. The goal is to keep the country's current-account deficit to about 16 billion kroner in 1980, reducing it steadily to achieve balance by the end of the decade. Critics note, however, that the package includes almost none of the tougher and politically sensitive measures—such as special taxes on property and autos, a tightening of eligibility rules for pensions, and a channeling of pension and insurance funds into industry—that were proposed in earlier negotiations. These same critics, which include the governor of the central bank, suggest that the package is so weak that further restrictions will be needed by autumn.

Israeli slowdown has eased inflation, but policy constraints are developing.

Evidence of an economic slowdown in Israel is increasing. The weakening is a response to the deflationary measures adopted toward the end of 1979. Credit curbs and limits on wage indexation agreements have led to real reductions in consumer spending, while industrial output is falling in almost all sectors of the economy. Consequently, real GDP growth is unlikely to reach the 2%-3% range officially forecast. The slowdown will have a positive impact on both inflation and the balance of payments in the medium term. Price increases are already in the range of 5%-7% per month, compared with 10%+ at the turn of the year. Nonetheless, inflation remains likely to average near 100% for the year as a whole. On the external-account front, declining import volume growth is being offset by higher oil prices, and the trade deficit is expected to continue to widen from its 1979 level of $4.1 billion. A policy conflict may emerge later in the year as the path toward economic equilibrium becomes more difficult. Specifically, the manufacturing industry and the export sector are being increasingly squeezed by adherence to strict deflationary measures, and unemployment is expected to rise from less than 4% as of end-1979 to some 5% by the end of this year.

New Zealand's economy in the doldrums.

Continued balance-of-payments deterioration coupled with rising inflation and weak domestic activity promise to keep New Zealand's economy in the doldrums in fiscal 1980/81, which began April 1. While public investment is likely to show some modest growth, private investment will continue to decline, owing to the Government's austerity policies. Industrial production is expected to advance about 3%-4%, compared with 2% growth in fiscal 1979/80, but agricultural output is likely to grow very little because of falling prices for wool, beef, and lamb. In addition, inflation looks set to rise from 14% last year to about 16%-17% this fiscal year as a result of large increases in wages and a rapid rate of money supply growth. Externally, the value of imports is projected to rise about 3% in real terms, while export growth is expected to slacken. New Zealand's current-account deficit is thus forecast to remain in the $700-million range. Overall, real economic growth for fiscal 1980/81 is forecast at about 0.5%-1.0%, only a slight improvement over last year's negative growth of 0.75%.

Argentina acts to stabilize its financial markets.

Argentina has made progress in reducing its high inflation rate and strengthening its balance of payments. The consumer price index through April 1980 dropped to an annual rate of 118%, down from 157% a year earlier. And booming grain exports have helped boost international reserves to nearly $10 billion in March, 133% above their March 1979 level. Real GDP grew 8.5% in 1979, and while a similarly high rate will not be repeated this year, growth of 3%-4% is possible. Nonetheless, problems have arisen in the banking sector. Three Argentine-owned banks have been placed under central bank guidance because of questionable managerial and lending procedures. The central bank has also had to increase its level of deposit guarantees substantially. Coupled with the economy's underlying strength, however, these measures should be sufficient to limit the stress in the financial sector and preserve banking soundness.

Honduran economy on an expansionary course.

The Honduran economy has been the most dynamic in Central America, a result of its government's commitment to spurring economic and social development. In recent years, the authorities have introduced comprehensive agrarian reform and have increased spending on social and physical infrastructure. The country is planning to exploit its vast forestry resources and is constructing a large hydroelectric dam, which should more than double Honduras' electrical-generating capacity and reduce the need for costly fuel imports. Economic growth has averaged 7.5% annually since 1975, a rate unmatched in the region, and government resolve to continue with its development plan should ensure growth in the 6%-7% range over the next few years. The expansionary nature of government programs, however, has helped widen the current-account deficit, pushing it to some 9% of GDP by 1978-79. The current-account gaps have been financed primarily with borrowings from multi- and bilateral lending institutions at concessionary terms, rather than through reserve depletion or commercial bank borrowing. As a result, Honduras' debt structure is not an ominous one, and the debt-service ratio stands at a manageable 10%.

Qatar's current-account surplus doubled in 1979.

The emirate of Qatar, an OPEC member whose crude oil output accounts for nearly all its export revenues, registered a current-account surplus of $1.7 billion in 1979, double the $850-million positive balance posted in 1978. Only a small part of this improvement, however, is attributable to last year's 4% rise in production (to 506,000 barrels per day). The major factor was the 50% jump in Qatar's weighted average official oil export price to $19.59 per barrel, which boosted net oil revenues to an estimated $3.3 billion. Such a steep rise far more than offsets the increase in imports of goods, net services, and transfer payments to approximately $1.6 billion. In 1980, the current-account surplus is projected to nearly double again. Official oil prices this year will probably average at least $30 per barrel, generating net oil earnings of about $4.9 billion. And even with a 22% rise in current-account outflows to $2 billion, the resulting surplus would be about $2.9 billion.

Tea prices may ease slightly through year-end.

Monsoon rains have brought relief to the drought-stricken tea-growing regions of Southern India, Sri Lanka, and Kenya. As a result, world tea prices should ease over the remainder of 1980. Dry weather in the prime tea-producing areas in the early months of the year helped push average tea prices to a peak of near $1.06 per pound in February, their highest level since March 1978. However, with the world tea harvest now picking up, and with little change expected in the overall level of consumption, the U.S. Department of Agriculture projects that tea prices will average between $0.98 and $1.02 per pound over the remainder of the year. Preliminary estimates forecast total tea production for 1980 at 1,473,000 metric tons, roughly the same as in 1978 and 1979.

Total Private Credit Demands to Slow

Private nonfinancial credit-market borrowing in the first quarter of 1980 rose sharply, according to just-released flow-of-funds data. The increase came mostly from the corporate sector. While some of the rise in corporate funds raised apparently reflected anticipatory borrowing spurred by fears of a credit crunch, it also reflected a widening gap between capital expenditures and internally generated funds. This "financing gap" will probably remain wide over the next few months, since corporate profits usually fall faster than capital expenditures in the early stages of a recession. Consequently, total corporate credit demands should remain relatively strong for the next few months. Significant weaknesses in consumer and mortgage credit demands, however, should cause total private credit demands in the near term to slow.

Total credit market funds raised by nonfinancial corporations in the first quarter were $125 billion on a seasonally adjusted annual basis, up from $89 billion in the fourth quarter of 1979. Capital expenditures outpaced internally generated funds by an annual rate of $76 billion, while the comparable financing gap in fourth-quarter 1979 was $62 billion.

Businesses also increased their holdings of liquid assets in the first quarter by a seasonally adjusted annual rate of $54 billion, compared with only $14 billion in the fourth quarter. One possible explanation for this extraordinary rise is that during the first quarter, and especially in late February and early March, fears emerged that the availability of credit would be curtailed severely. Businesses thus increased their liquidity positions in preparation for any such credit crunch.

No severe credit crunch materialized. However, the increase in corporate liquidity may offset to some extent the effect of any increase in the financing gap on total credit-market borrowing, as corporations reduce their rate of liquid-asset accumulation. This offset may be minimized around the mid-June tax date, however, since corporate balance sheet data suggest that June corporate tax payments will be quite large.

Even if total corporate borrowing remains strong, weaknesses in credit-market borrowing by other sectors should more than offset any such strength. Recent data on housing starts, housing permits, and mortgage commitments all point to continued sluggish growth in mortgage credit over the next few months. And recent retrenchments in consumer spending patterns suggest that consumer credit growth has been falling sharply and may continue to slump in the near term. In fact, April and May figures for consumer instalment credit may show consumer credit outstanding actually declining in these months. In sum, total private credit demands should prove to be significantly weaker in the second quarter.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE				
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	us cre lions
Austria	Inflation still rising, but real growth expected to decline to 2% from 5% in 1979.	Dec.	+ 7.6%	68.9	+ 5.3%	Mar.	3,771	− 14.8%	2.2	
Belgium	Economic growth forecast for 1980 revised down to 1.5%; inflation rate projected at 7%.	Dec.	+ 1.3%	111.5	+ 3.0%	Mar.	4,109	− 31.1%	0.8	
Britain	Unemployment rising rapidly as demand continues weakening and as wage increases reach 20%.	Jan.	+ 3.9%	391.2	+ 0.5%	Mar.	19,993	+ 12.2%	2.3	
Denmark	New deflationary measures will produce virtually zero growth in 1980.	Jan.	+ 6.1%	65.6	+ 2.5%	Mar.	1,839	− 56.2%	1.2	
Finland	Economic growth of 4% expected in 1980, versus record 7.5% in 1979.	Dec.	+ 7.4%	41.6	+ 7.3%	Mar.	1,672	+ 14.0%	1.6	
France	New industrial orders decline.	Jan.	+ 3.2%	566.9	+ 3.0%	Mar.	21,065	+ 38.9%	2.3	
Germany	Economy still strong, with industrial output rising an annualized 5.3% in first quarter.	Feb.	+ 6.4%	755.8	+ 4.3%	Mar.	46,217	− 5.4%	3.3	
Ireland	Economic growth slowing in response to deflationary 1980 budget.	Sept.	+ 8.9%	14.9	+ 3.3%	Mar.	2,035	− 16.8%	2.3	
Italy	Industrial production sustains strong rise in first quarter.	Jan.	+ 7.7%	318.6	+ 4.0%	Mar.	19,168	+ 18.2%	3.0	
Netherlands	Fiscal and incomes-policy tightening preclude any real economic growth this year.	Jan.	+ 0.3%	151.8	+ 3.3%	Mar.	8,484	+ 9.4%	1.5	
Norway	The economy continues to grow rapidly, owing to oil.	Feb.	+ 1.7%	45.3	+ 2.8%	Mar.	4,462	+ 21.5%	3.7	
Portugal	Government's desire to ease deflationary policy inhibited by renewed balance-of-payments deficit.	Oct.	+ 8.7%	20.2	+ 3.0%	Feb.	814	+ 6.5%	1.6	
Spain	Outlook unfavorable, with unemployment rising and domestic economy virtually stagnant.	Sept.	0	197.4	+ 1.5%	Feb.	13,417	+ 31.7%	6.2	
Sweden	Bitter labor disputes now resolved, with new settlements of some 7%.	Jan.	+ 8.0%	103.3	+ 4.0%	Mar.	3,375	− 11.4%	1.3	
Switzerland	Business outlook continues favorable.	Dec.	+ 4.0%	94.1	+ 0.3%	Mar.	13,483	− 19.0%	5.1	
Turkey	New one-year stand-by loan being negotiated with IMF; inflation rising from last year's 80%.	Nov.	0	66.1	+ 1.0%	Feb.	825	+ 9.7%	2.0	
Canada	Industrial output decline in February presages overall output slowdown.	Jan.	+ 0.6%	222.8	+ 2.8%	Mar.	2,715	− 38.6%	0.6	
United States	Rising unemployment confirms economy in recession.	Apr.	0	2,349.0	+ 2.0%	Mar.	10,280	+ 1.0%	0.5	

Food Price Outlook Clouded

The struggle against inflation received an important psychological boost earlier this month with the report that the rate of increase in producer prices had slowed significantly in April. Thanks largely to a decline in the prices retailers pay for finished food products, the Producer Price Index (PPI) for finished goods rose only 0.5% last month. This was far less than the 1.3% average monthly increase for the previous nine months. The fall in wholesale food prices in April was a spectacular 2.8%, the steepest monthly drop since June 1974. It reflected sharp declines in the wholesale prices of beef, pork, and poultry.

Nevertheless, consumers are likely to be especially hard hit by higher meat prices in the second half of the year. High interest rates and the collapse of wholesale prices for poultry and livestock have cut into profits for producers of these animals. Pork and poultry producers, unable to cover their production costs, are rapidly trimming supplies. And the number of new beef cattle placed on feed in the first quarter of this year was the lowest since 1975.

These developments point to sharply reduced marketings of meat and poultry later in the year. Because these items account for more than one-third of consumers' home food budgets, some analysts are warning that soaring meat prices will push overall retail food price increases into double digits by year-end. Such pessimism, however, may not be warranted.

First of all, retail food prices depend on consumer demand as well as on supply-side influences. When purchasing power declines in a recession, consumers typically reduce their consumption of expensive meat products and substitute greater amounts of cheaper foods. This tends to limit increases in meat prices. The duration and severity of the current recession will thus determine the extent to which reduced demand will offset the supply-related upward pressures on meat prices.

Furthermore, the outlook for other components of the retail food price index is not as gloomy as for meat. To be sure, heavy rains in California earlier in the year and a late freeze in Florida have triggered some short-term increases in fresh vegetable prices. But barring unforeseen weather or harvest problems, supplies of most vegetable items are likely to be ample, with prices continuing below year-earlier levels.

For still other components, the outlook is mixed. Although production of dairy products is expected to continue increasing, prices will still be determined largely by government price-support policy. Sugar has been a highly volatile commodity this year, and shortfalls to date in foreign production are likely to push retail prices for refined sugar still higher.

Beyond the outlook for raw food prices, marketing costs will remain a major contributor to price rises throughout 1980. A slowing economy, however, may help moderate some of the increases in energy, labor, transport, and inventory financing costs that have contributed to rising food bills in the past.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
f IMF t, mil- dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate May 21, 1980	exchange rate in U.S. dollars	current monetary conditions	
0	Current-account gap 9.9 billion schillings in first quarter, versus 5 bn. in 1979.	Feb.	+ 5.4%	Jan.	+17.0%	6.75%	.0780	Monetary conditions remain restrictive.	**Austria**
0	More costly oil imports and weak exports widen trade gap.	Mar.	+ 6.5%	Dec.	+14.5%	14.00%	.0347	Interests rates ease slightly as pressure on franc subsides.	**Belgium**
0	Exports strong despite sterling's strength, but current account continues in deficit.	Apr.	+21.8%	Dec.	+22.6%	17.00%	2.3300	Loan demand unresponsive to high interest rates.	**Britain**
0	Current-account gap likely to reach 16 billion kroner in 1980.	Feb.	+13.3%	Oct.	+10.1%	13.00%	.1792	Credit conditions remain highly restrictive.	**Denmark**
83	First quarter current-account gap 762 million markkaa, vs. surplus year ago.	Mar.	+ 9.6%	Nov.	+17.4%	9.25%	.2708	Markkaa revalued 2% in March to check imported inflation.	**Finland**
0	Substantial current-account deficit expected this year.	Mar.	+13.7%	Aug.	+13.6%	9.50%	.2398	Firm-exchange-rate goal makes early rate decline unlikely.	**France**
0	Current-account deficit continues large; government borrows abroad.	Apr.	+ 5.7%	Jan.	+12.2%	7.50%	.5589	Interest rates raised further.	**Germany**
0	Trade deficit narrowing, but large current-account gap expected in 1980.	Feb.	+15.6%	Feb.	+24.4%	16.85%	2.0850	Interest rates exceptionally high.	**Ireland**
0	First-quarter trade gap 3.8 trillion lira, vs. lit. 74-billion gap year earlier.	Mar.	+21.3%	Nov.	+19.2%	15.00%	.001187	Interest rates to rise further.	**Italy**
0	Export volume expected to grow 1% in 1980; import volume to fall.	Feb.	+ 5.9%	Dec.	+17.2%	10.00%	.5075	Discount rate boosted.	**Netherlands**
0	Higher oil prices may yield first payments surplus since 1969.	Mar.	+ 8.5%	Oct.	+16.1%	9.00%	.2040	Government to retain tight money and credit policy.	**Norway**
8	Current-account gap of $875 mn. likely in 1980, vs. $150-mn. surplus in 1979.	Feb.	+22.7%	Dec.	+27.4%	17.00%	.0204	Monetary conditions remain restrictive.	**Portugal**
7	Current account firmly in deficit, following oil price rise.	Jan.	+16.8%	Feb.	+18.7%	8.00%	.0141	Large budget deficits leading to credit tightening.	**Spain**
0	Current-account deficit of about 17 billion kronor expected in 1980.	Mar.	+13.5%	Dec.	+18.6%	10.00%	.2375	Government extends temporary freeze on prices.	**Sweden**
0	Current-account deficit threatens.	Apr.	+ 4.1%	Jan.	+16.3%	3.00%	.6013	No early easing of credit conditions anticipated.	**Switzerland**
0	Oil imports boost first-quarter trade gap to $1 billion.	Dec.	+81.1%	Feb.	+14.4%	10.75%	.0135	Lira devalued further against mark, but not against dollar.	**Turkey**
0	Imports decline as business activity lags.	Apr.	+ 9.2%	Dec.	+22.6%	13.34%	.8620	Interests rates on downtrend.	**Canada**
0	Oil price hikes contribute to large first-quarter trade deficit.	Mar.	+14.7%	Apr.	+ 9.4%	13.00%	—	Money growth well below Federal Reserve targets.	**United States**

World Interest Rates

market rates of May 21, 1980; bond yields as of May 16, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	13.34	17.00	14.00	9.50	7.50	15.00 penalty rate 18.00	10.00	3.00	9.00
Day-to-Day Money	9.50 May 22	16.00	15.50	14.45	13.00	9.55	17.00	11.125	4.75	12.8125
Treasury Bills 91-day, Middle Rates	8.06	11.75	16.00	15.75	n. a.	n. a.	15.05 101-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	9.00 finance paper	12.125 finance paper 15% tax w/h	14.76	13.90 Certified	12.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.75	12.05 15% tax w/h	16.4375	15.25 Certified	not traded	9.90	18.50	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.57	11.75	13.69	10.82 20% tax w/h	12.80	8.59	15.02	10.03	4.83	8.65
Industrial Bonds prime, long-term, new and old issues, average yield	11.25 Aa Industrials	12.125	14.42	14.49	14.09	8.78	14.95	10.98	5.74	7.51
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50*	14.75	18.00	18.75	14.60	11.50	20.00	13.00	5.50	9.25
Bank Time Deposits 3-month	9.00 Cert. of Dep.	12.00 Cert. of Dep.	16.9375	16.00	12.875	10.00	10.75	11.375 large deposits	6.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	10.1875*	no market	17.625*	no market	13.00*	9.625*	no market	11.125*	10.0625*	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8620	2.3300	.03470	.2398	.5589	.001187	.5075	.6013	.004453
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.375 *D*	6.875 *D*	5.50 *D*	2.875 *D*	.875 *P*	6.875 *D*	1.00 *D*	4.375 *P*	2.75 *P*

Eurodollar Deposits

(London, interbank, bid)
May 22

7-day	8.625
1-month	9.8125
3-month	10.0625
6-month	10.0625

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .84
U.S.-Canada Treasury Bills	−1.80
U.S.-Canada Finance Co. Paper	−1.34
Eurodollars-U.K. Local Auth. Deposits	+ .31

Eurobonds**

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.25
Over 7 yrs.	11.625
DM Bonds	
7 yrs. and under	9.00
Over 7 yrs.	9.00

Gold Price

London
afternoon fixing

513.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of May 22. ** Rates as of May 14.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.7 (Mar.)	9.2 (Apr.)	21.8 (Apr.)	13.7 (Mar.)	5.7 (Apr.)	21.3 (Mar.)	4.1 (Apr.)	8.0 (Mar.)
Industrial production*	−1.5 (Apr.)	0.7 (Mar.)	−3.4 (Mar.)	3.0 (Mar.)	4.9 (Mar.)	7.0 (Mar.)	4.0 (Dec.)	11.6 (Mar.)
Trade balance† *(billions of local currency units)*	−$3.2 (Mar.)	C$.70 (Mar.)	−£.26 (Apr.)	−FF2.0 (Apr.)	DM2.0 (Mar.)	−Lit.384 (Mar.)	−SF1.26 (Apr.)	−¥267 (Apr.)
Money supply (M_1)*	3.8 (Apr.)	6.1 (Apr.)	5.9 (Mar.)	9.5 (Jan.)	−1.1 (Feb.)	25.5 (Nov.)	−12.5 (Feb.)	8.0 (Mar.)
Velocity of money (M_1)*	3.9 (Dec.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	−3.1 (June)	n. a.	3.8 (Dec.)
Reserves minus gold *($ million, change from previous month)*	608 (Mar.)	−756 (Mar.)	−563 (Mar.)	944 (Mar.)	−2,902 (Mar.)	169 (Mar.)	−183 (Mar.)	169 (Mar.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

Greece Prepares for EEC Membership

The Greek economy is currently straddling the industrialized and developing worlds. Greece's 1978 per capita income of $3,400 is about half the European Economic Community (EEC) average and equivalent with that of Ireland. Yet manufacturing now accounts for about one-third of total output, and this proportion continues to increase.

Following the fall of the military dictatorship in 1974, the Government of Constantine Karamanlis pursued policies aimed at sustaining Greece's rapid economic growth, which had averaged some 7% per year between 1957 and 1973. And indeed, despite the 1973-74 oil price explosion, Greece's economy did manage to grow at an average annual rate of 4.8% in the 1975-79 period, compared with an EEC average of just 2.4%. Furthermore, until only recently rapid growth in earnings from exports and invisibles (particularly shipping, tourism, and worker remittances) held Greece's current-account deficits to manageable levels.

The rapid growth, however, eventually produced imbalances in the distribution of the national product. Wage increases, in particular, rose by some 25% per year between 1973 and 1978, while annual price increases were held to 16%. The resulting 9% average annual real wage growth far exceeded the growth in productivity (and was especially disturbing in view of the 3% annual deterioration in Greece's terms of trade). The fast wage growth led to a profit and investment squeeze, causing private manufacturing investment to decline over the 1974-79 period. It also set the stage for an acceleration in the inflation rate as profits could no longer absorb high labor costs. Moreover, the surge in private consumption triggered a balance-of-payments deterioration that was compounded in 1979 by another round of oil price increases.

Responding to these problems, the Greek authorities tightened monetary policy and introduced public spending cuts, mainly in investment. The public-sector borrowing requirement is provisionally estimated to have dropped from 5.1% of GDP in 1978 to 4% in 1979. Monetary growth also decelerated over the course of 1979, with year-over-year M_1 growth estimated to have fallen from 22% in 1978 to less than 16% last year.

The corrective policy measures adopted in mid-1979, however, came too late to halt a sharp deterioration in key economic indicators last year. While real GDP growth is estimated to have slowed to 3.9%, consumer prices at the end of 1979 were 24.5% above their end-1978 level, yielding an average inflation rate of 19% for the year. And the current-account deficit is estimated to have widened from $1.2 billion in 1978 to about $2.3 billion in 1979. Some $800 million of the current-account deterioration was the direct result of a higher oil bill. Net oil imports rose from $975 million in 1978 to $1.8 billion in 1979, reflecting a higher oil import volume and heavy spot market purchases.

At the same time, private capital inflows declined slightly in 1979, forcing an increased reliance on public loans, trade credits, commercial bank funding, and private borrowing to finance the current-account gap. Greece's total external debt (including expatriates' deposits) is estimated to have risen from $8 billion in 1978 to more than $10 billion, with the 1979 debt service equal to 21% of exports and to 10% of current-account earnings.

Late in 1979, the authorities took further actions in their battle against inflation and the balance-of-payments dislocation. Interest rates were boosted, and the Government announced that the public-sector deficit would be pared down further to 3.1% of GDP. Furthermore, a 75% six-month import deposit scheme and a 25% consumer tax—both on non-essential imports—were introduced. But most importantly, the authorities announced an incomes policy to hold wage increases to less than 18%.

Although the average inflation rate in 1980 is forecast to be about the same as in 1979—approximately 19%—the rate is expected to decline during the second half of the year. Private consumption is expected to show very little growth, and the volume of construction output looks set to decline by 10%. The current-account deficit, on the other hand, is likely to rise to $2.5 billion from $2.3 billion last year. This projection is based on the anticipation of a higher oil bill, however, and masks an estimated $450-million likely improvement in the non-oil current-account balance. The net effect of the Government's deflationary policies will be to cut real GDP growth to about 1.5% in 1980, well below earlier official forecasts.

On January 1, 1981, Greece will become the tenth member of the European Economic Community. Although the country has been an associate member for some time, with already very low industrial tariffs on EEC-country imports, it will still have to phase out substantial export subsidies to its industrial exporters. Membership will also require the eventual relaxation of capital controls and greater freedom of the domestic financial market. In the short run, EEC membership will have a beneficial impact on agricultural exports and will increase the likelihood of government-to-government balance-of-payments assistance from other EEC countries. Over the longer term, Greece's labor cost advantage and relatively advanced infrastructure should attract investment from other EEC partners. Furthermore, access to Community markets and the release of labor from an industrializing agricultural sector should sustain real average annual GDP growth of 4%-5% in the 1980s.

George de Nemeskeri-Kiss, Chase London

The Nature of the Asiacurrency Market

The Asiacurrency market, just as its Eurocurrency precursor, was created by international banks seeking to overcome national barriers to international financial intermediation. Both offshore markets are aimed at satisfying the massive financial requirements of worldwide industrial development with maximum flexibility, using the U.S. dollar as a predominant transactions currency. The only real differences between the two markets are those of size and geography. But although the $38-billion Asiacurrency market is still in its early stages, compared with the trillion-dollar Euromarket, its impact on the Asian region it services is no less significant.

In addition to its function of financial intermediator between several Asian nations and the Eurocurrency market, Asiamarket participants arbitrage between financial markets in Asia, the Middle East, and Europe. The market is also an important conduit for channeling economic development funds into the Asia-Pacific area. But perhaps its greatest contribution is the substantial business cost savings made possible by its operation and geographic location.

The Asiamarket was launched in Singapore in 1968, a period marked by rapid industrialization and decolonization of Singapore's economic structure in the wake of independence from Great Britain. Complementing domestic industrial development was Singapore's expansion of its external financial and trade relations, which spurred the emergence of the Asiacurrency market. The market's development is integral to Singapore's strategy of stimulating the development of a large and sophisticated financial sector to serve the Asia-Pacific region, in addition to increasing the inflow of financial resources for domestic use.

To promote the development of the Asiacurrency market, the Monetary Authority of Singapore has sought to maximize the flexibility of its offshore currency market, insulating it from domestic financial market restrictions. Specific actions taken over the last 12 years have included exempting Asiamarket transactions from exchange controls, abolishing withholding and other taxes on non-residents' income on foreign-currency deposits, and eliminating minimum reserve requirements against foreign-currency deposits. In response, the number of banks operating in the Asiacurrency market—both foreign and domestic—rose from one in 1968 to 101 by the end of 1979.

The Monetary Authority has also taken steps to ensure responsible financial practices in the Asiamarket. The Banking Act of 1979, for example, requires foreign commercial banks to establish branches rather than subsidiaries in Singapore so that bank home offices bear the full risk of insolvency.

Singapore has also acted to protect its domestic banking industry from being squeezed out by Asiamarket banks. Full-service banking licenses have not been granted to foreign banks since the market's inception. And since 1973, foreign banks have been eligible only for offshore-banking licenses. Foreign banks are permitted to accept local funds only through the interbank market, and deposits from residents must be at least S$250,000. Their local lending is also restricted. The Government's basic objective is to limit non-domestic banks to those areas of local business that complement, rather than compete with, fully licensed local banks.

The development of the Asiamarket has also altered Singapore's traditional financial-market relationship with Hong Kong. Singapore's elimination of exchange controls and the reduced rate of taxation on income from offshore-banking activities (from 40% to 10% in 1973), accompanied by Hong Kong's imposition of a 17% corporate tax on bank offshore earnings, have elevated Singapore's status as a financial center to a level equal with that of Hong Kong. Hong Kong, however, retains the advantages of superior ancillary facilities, a laissez-faire environment, and close proximity to market information and participants. It thus appears likely that Hong Kong will continue to play the role of regional "deal maker," tapping the growing Asiacurrency market in Singapore for funding.

The suppliers and borrowers of Asiacurrency funds have changed significantly since 1968. In the early years, non-bank deposits accounted for more than two-thirds of total Asiamarket liabilities, while loans to the non-bank sector were less than 5% of total assets. Since then, mainly because of the international liquidity explosion of the post-OPEC period, interbank deposits have come to dominate market activities. Indeed, the proportion of deposits from the non-bank sector now accounts for only 15% of total liabilities. As for non-bank loans, these accounted for more than 22% of total assets in 1979. Non-bank borrowers have traditionally consisted of large regional and national companies. But since the OPEC price explosion of 1974, governments and their agencies have loomed large as borrowers. Moreover, since 1974 an increasingly larger portion of Asiamarket funds are used to finance energy-related activities.

The Asiacurrency market has already shown remarkable flexibility in adjusting to the post-OPEC world by innovating in response to the strains in the international payments system. And current economic trends—including the move toward monetary tightening in the West, the increasing internationalization of capital markets, and bright prospects for Asian economic expansion—promise continued growth for the Asiamarket in the 1980s.

Raymond Ch'ien
Chase Hong Kong

CHASE

International Finance

Vol. XV, No. 12
June 9, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

6/9/80 B 1900-1 U

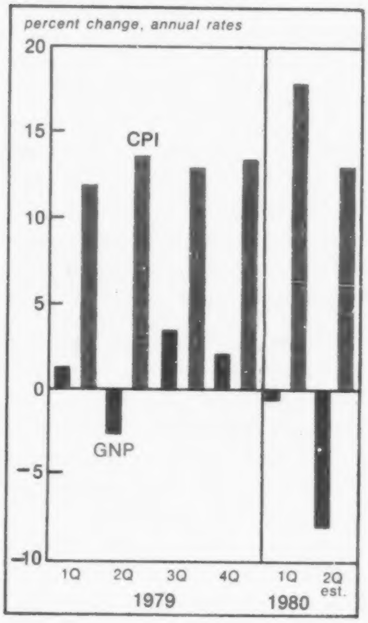
U.S. Recession Begins With a Bang

The long-awaited recession is clearly under way in the United States. Industrial production fell by a total of more than 2½% in March and April, and the decline apparently continued in May. New orders for manufactured goods dropped 5.5% in April—the largest monthly reduction in more than five years. In one recent week, new claims for unemployment assistance set a record.

The recession apparently began in February. Housing construction and automobile sales had been weak for almost a year. But there had been enough strength elsewhere in the economy to permit slow growth in total activity. By late winter, however, the combination of extremely high interest rates and the effect of roaring inflation on real incomes finally began to reduce consumer spending for a broadening range of products. More recently, declining final sales apparently triggered a general move to reduce business inventories. Just in the past month or so, there has been an increasing number of reports of cutbacks in business capital spending programs.

This recession is somewhat unusual in that it involves an inventory adjustment early in the period of contraction; ordinarily, the inventory reduction comes much later, during the final process of adjustment that precedes recovery. This raises some hope that the current decline may be relatively brief; the most recent recession that involved an early inventory cutback was that of 1957-58, which was the shortest of the six post-World War II recessions. Regardless of duration, however, this downturn appears to have the potential of developing into quite a deep decline. According to some estimates, real GNP may fall during the current quarter by an amount greater than the total decline in three of the last six recessions.

U.S. real economic growth and inflation



Two other current developments should contribute to bringing about eventual recovery. One is the precipitous drop in interest rates. While fewer new housing units will probably be started in 1980 than in any other year since the war, lower interest rates promise the battered construction industry some relief by yearend. Even more importantly, the rate of price inflation has at last begun to abate. From about 18% in the first quarter, the annual rate of increase in the Consumer Price Index fell to 11½% in April. While there are bound to be several more bad months in the near future, the rate of price inflation should drop further as the year progresses.

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U.K. recession now underway, but monetary policy remains tight.

Recent statistics confirm that the long-awaited U.K. recession has now begun. The volume of retail sales is down 2.9% from its year-ago level, the index of industrial production is down 3.6%, and unemployment stands at 6%, versus 5.5% in January. Despite the slowdown, the balance of payments continues in deficit, registering a shortfall of £214 million in April for a cumulative deficit of £787 million so far this year. In addition, wage settlements show no sign of moderating. Average earnings in March were 20.1% above March 1979 levels. The Government is nonetheless sticking firmly to a restrictive monetary policy, and short-term interest rates stand at 17%. High returns for overseas investors have accordingly boosted the pound to a five-year high of 2.37 against the dollar, and have lifted the mark/pound rate back to 4.18. The financial markets expect the next move in U.K. interest rates to be downward, but opinion remains divided as to how soon the shift will occur. While the August-September period is most probable, a continued strengthening of the pound might force an earlier interest rate reduction.

Revised projections point to steeper Dutch economic growth slowdown.

Recent projections by the Dutch Central Planning Bureau suggest a gloomier economic outlook than previously forecast. On the external front, weaker economic growth prospects for Holland's trading partners will result in reduced demand for petroleum products, chemicals, and metals—items that constitute a large part of Dutch exports. Domestically, fiscal policy has been tightened. Public spending has been cut by an additional three billion guilders, and a restrictive incomes policy will hold real earnings this year to their 1979 level, implying a real decline for higher-income groups. As a result, inflation-adjusted consumption expenditure is projected to remain flat this year after rising 2.5% in 1979; industrial investment is expected to fall by 2% after rising 2% last year; and export volume growth will likely decline from 9.5% in 1979 to only 1% this year. Real GDP is thus expected to show virtually no growth in 1980, although the Dutch inflation rate will probably climb to 6% from 4.25% last year.

Mexico's new development plan projects rapid economic growth through 1982.

Mexico's recently released Global Development Plan for 1980-82 projects a continuation of the 8% real GDP growth posted in 1979. Relying on increased petroleum output and a high rate of public investment spending, the new Plan calls for more resources to be allocated to agriculture, rural development, transportation, and communications. These have been the only lagging sectors in an otherwise rapidly developing economy. The Plan also projects a high level of private investment spending over the next three years, with the total investment-to-GDP ratio likely to reach 27% by 1982. Job creation is a focus of considerable emphasis in the Plan, in view of the country's large number of unemployed and underemployed workers. With the availability of increasing petroleum revenues, the 1982 economic output goals of the new Plan should be attainable, but a satisfactory level of employment creation will probably take longer to achieve.

Philippine current account to be deeply in deficit in 1980-81.

Economic prospects for the Philippines are dimmed by the latest round of oil price hikes and by declines in domestic oil output and in world commodity prices. The current account is expected to show a deficit of $2.4 billion in 1980—large exports of sugar, copper concentrates, and gold will partly offset higher oil prices and declining world prices for coconut oil. And unless commodity prices improve, the deficit will widen to about $3.2 billion in 1981. Such deficits should prove manageable, however, given the high level and favorable terms of IMF and World Bank support. Long-term debt is expected to increase to approximately $11.5 billion by end-1981 from $7.9 billion as of end-1979, but the country's debt-service ratio should not exceed 20% and may actually decline slightly.

Uruguayan economic growth slowing from record rate in 1979

The Uruguayan economy achieved a record real GDP growth rate of 8.3% in 1979, a significant improvement over the 3% annual average advance of the 1973-78 period. Strong incentives to growth came primarily from the international sector. These consisted of higher meat export prices, strong earnings from tourism, and capital inflows from Argentina. There was also a boom in luxury and resort residential construction, with sales almost entirely to Argentines. Modest investment in the manufacturing sector added to final demand, pushing the investment-to-GDP ratio to 24%, compared with 13.5% in 1978. So far this year, the economy has shown some weakness as a result of the combination of a 75% annual inflation rate affecting consumer demand and a cooling off of the construction boom. On balance, the rate of real economic growth in 1980 is expected to slow to 4%-5%.

Belgian current-account deficit widening, despite slow economic growth.

Poor European economic growth prospects are straining Belgium's export-dependent but structurally rigid economy. The country's current-account deficit has already increased dramatically, rising from $900 million in 1978 to $3.8 billion last year. Given an additional 60% jump in oil import costs and a weakening of exports, containment of the deficit in 1980 would require a substantial slowdown in domestic demand. The alternative of devaluation is not feasible for Belgium, which possesses a rigid system of wage indexation and a high import ratio—imports are equivalent to half of GDP. This leaves protection of the franc through high interest rates, an option that would hurt industrial investment. Belgium's external-account problem is compounded by the importance of exports of steel, chemicals, and textiles—industries sensitive to the global slowdown. In sum, despite the latest real economic growth forecast of only 1.5% for 1980, a widening current-account deficit is anticipated.

Liberia's export-dependent economy hurt by global recession.

Stagnation and growing dependence on foreign capital have characterized the Liberian economy throughout the 1970s, with the near-term outlook likely to be much the same. As one of the world's leading producers and exporters of iron ore, recessionary trends in the world steel industry have had a severe impact on both the domestic and foreign sectors of Liberia's economy. Export growth has not kept up with inflation, and real GDP growth has been increasing at a rate below that of population growth. Although the country's current-account deficit has narrowed from $138 million in 1977 to an estimated $75 million in 1979, the shortfalls have led to an increased dependence on foreign borrowing. With attempts at export diversification having met with only limited success, the unfavorable outlook for the world steel industry does not bode well for Liberian iron-ore exports, which constituted 54% of total exports in 1979. Similarly, the outlook for rubber, a source of 16% of export earnings last year, is less than encouraging because of the global recession. The uncertain economic outlook is further complicated by the unsettled political situation triggered by the April 12 coup.

Export credit costs set to rise slightly on July 1.

Last month, 22 OECD-member participants in an international accord on export credits agreed to a slight boost in minimum interest rates. Beginning July 1, lending rates on all categories of exports financed with government support will rise as follows: for "rich" and "intermediate" countries, rates on export credits of five years and over will climb to 8.75% and 8.5%, respectively, from their current levels of 8% and 7.75%; for "poor" countries, the rate will rise from 7.5% to 7.75%. The United States, Canada, and several other OECD members in favor of raising the current low minimums to market-related levels have accepted the small rate increase as only a temporary measure. A December 1 deadline has been set by which time several formulas for fixing minimum interest rates tied to movements in money-market rates will be studied. (Possibilities include having minimums vary among the lending countries in response to changes in government bond yields—with adjustments for currency differences—or periodic uniform adjustments in the current rate structure reflecting world money-market movements.) If no new formula can be achieved by December, the present accord may begin to disintegrate, raising the possibility of an export credit war among the industrialized nations. In the interim, U.S. officials will press the issue at the upcoming seven-nation economic summit in Venice and push for standby additional funding for the financially strained U.S. Export-Import Bank.

Federal Budget Balanced on a Tightrope

Soon after the Carter Administration unveiled its fiscal 1981 budget – which contained a $16-billion deficit – the U.S. Congress made efforts to balance it. Seeking to better the Congress, President Carter submitted a revised budget just two months later that showed a $16-billion surplus. However, events of the past few months have made any surplus all but unobtainable. Indeed, it is quite likely that the fiscal year 1981 budget will be substantially in deficit, despite the wishes of the President and Congress.

The pressure to increase defense spending sharply is one threat to a balanced budget. The first Congressional budget resolution—to have been passed on May 15 but still in dispute—sets overall targets for expenditures and receipts by broad categories. The shared determination to keep the budget at least nominally in balance has led to an extraordinarily divisive debate on how much increased defense spending can be accommodated. The House and Senate Budget resolutions are about $8 billion apart on the issue. It thus remains to be seen if this "guns *or* butter" policy, in contrast to the previous "guns *and* butter" policy, will help keep spending in check.

A more serious threat to a balanced budget stems from the extremely rapid deterioration of the economy in recent months. The Congressional estimates of receipts and expenditures are based upon forecasts made in March, when the unemployment rate was 6.2%. That forecast showed unemployment rising to 7.3% by yearend 1980 and to 7.6% by yearend 1981. But the April unemployment rate has already hit 7%, and it appears certain to move much higher in the coming months as the recession unfolds. Higher-than-expected unemployment will trigger increased spending for various income maintenance programs. And lower levels of business activity will lead to a shortfall in receipts, further increasing the probability and magnitude of a budget deficit.

The worsened economic outlook need not necessarily throw the budget off balance; non-recession-related spending could conceivably be cut. However, such cuts in expenditure would needlessly deepen the already-painful recession now under way. Indeed the recession's force has led to calls for tax cuts to ease the decline; this would clearly dash any hopes for a balanced budget in fiscal 1981.

Budgetary balance has acquired a certain symbolism in the public mind as an effective anti-inflation tool. But a budget deficit during a recession-plagued year—even allowing for a modest tax cut—should not necessarily be taken as a sign that Congress lacks the discipline to combat inflation. The real test will be whether the budget will be in balance—or in surplus—as the economic recovery takes hold.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE O				
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cre lions
Asia	**Bangladesh**	Improved political climate and relaxation of controls boost private investment significantly.	Jan.	+ 16%	8.9	$ 103	Apr.	338	− 7%	1.9	
	Burma	Real GNP growth estimated at 6% for fiscal 1979/80, owing to favorable rice crop.	Jan.	+ 59%	4.3	128	Apr.	264	+ 80%	8.0	
	China, People's Republic	Real economic growth expected to slow to 5.5% this year from 8% in 1979.	Mar.	+ 37%	515.0	510	June '79	3,538	+ 11%	3.0	
	Hong Kong	A 27% increase in public expenditure will bolster economic activity this year.	Mar.	+ 36%	16.6	3,320	n.a.	—	—	—	
	India	Tea output fell by more than 50% in first quarter, the result of poor weather.	Jan.	− 14%	121.1	188	Mar.	7,204	+ 3%	8.0	
	Indonesia	Government boosts fuel prices by 50% in effort to reduce subsidy costs.	Dec.	+ 35%	43.4	289	Apr.	4,825	+ 53%	6.1	
	Japan	Housing starts declined 0.8% in fiscal 1979/80 in response to higher mortgage costs.	Apr.	+ 23%	948.0	8,243	Apr.	18,246	− 28%	2.0	
	Korea	First-quarter real GNP growth was 1.7%, compared with 13.1% in first-quarter 1979.	Mar.	+ 22%	61.1	1,624	Mar.	2,697	+ 1%	2.0	
	Malaysia	Manufacturing output increase forecast at 8% for 1980, down from 10% in 1979.	Nov.	+ 41%	17.3	1,310	Feb.	4,008	+ 20%	5.7	
	Nepal	Agricultural production forecast to rise 3% in 1980.	Dec.	− 7%	1.5*	114	Mar.	180	+ 16%	9.0	
	Pakistan	Wheat output in 1980 expected to reach 10.8 million metric tons, surpassing official target.	Dec.	+ 46%	20.9	265	Apr.	886	+ 66%	1.9	
	Philippines	Tight credit and fuel costs expected to cut 1980 manufacturing growth to 4% from 5.5% in 1979.	Mar.	+ 48%	29.1	612	Apr.	2,541	+ 31%	4.0	
	Singapore	Domestic economy will be boosted by construction of $700-million petrochemical complex.	Jan.	+ 51%	8.9	3,708	Jan.	5,938	+ 12%	4.0	
	Sri Lanka	Real GDP growth rate this year estimated to slow to 4% from 5% in 1979.	Dec.	+ 17%	3.1	206	Mar.	413	− 4%	3.8	
	Taiwan	Output of heavy industry slowing this year because of rising fuel costs.	Mar.	+ 34%	27.6	1,623	Mar.	1,509	+ 5%	1.0	
	Thailand	Budgeted government expenditure set to rise 16% in 1980.	Nov.	+ 25%	26.0	565	Apr.	1,729	− 19%	3.1	
Oceania	**Australia**	Drought will severely curtail agricultural production this year.	Mar.	+ 35%	124.0	8,551	Apr.	1,692	− 22%	1.3	
	New Zealand	Sheep production expected to increase 7% this year.	Mar.	+ 28%	15.4	4,812	Mar.	545	− 10%	1.0	

*1978

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CD Funding More Attractive to Banks

While business loans at large banks fell by a massive $4 billion from mid-April to mid-May, there was virtually no decline in large "negotiable" certificates of deposit (CDs) outstanding over this period. At first glance this seems somewhat surprising, since business loans are often funded with CDs. But at least one reason for this unusual behavior is that the effective borrowing cost to banks of raising funds in the CD market since mid-April has been significantly below that of raising funds in the Eurodollar market. This has induced banks to increase the volume of CDs outstanding relative to their Eurodollar borrowings. At least one implication of this shift is that since a greater amount of reserves must be held against CD balances as against net Eurodollar borowings, the growth rates of both bank reserves and the monetary base have been greater than they would otherwise have been over the last few weeks.

For banks that are members of the Federal Reserve, reserve requirements against CD balances maturing in 90 days are eight percentage points greater than those applicable to Eurodollar borrowings of comparable maturity. Since these reserves yield no interest, the effective borrowing cost to banks at any given interest rate is about 8% greater in the CD market than in the Eurodollar market. Typically, the workings of the market result in 90-day Eurodollar rates being not too far from 8% above 90-day CD rates.

Since mid-April, however, 90-day Eurodollar rates have on average been more than 12% above 90-day CD rates. Based on the average level of interest rates prevailing during this period, this translates into an annualized effective borrowing cost differential of more than 40 basis points in favor of 90-day CDs.

This differential has led banks to increase CD balances relative to net Eurodollar borrowings. From mid-April to mid-May, net borrowings of large banks from their foreign branches fell by $4 billion. As it turns out, this decline was approximately equal to the drop in business loans.

While it is unlikely that this wide differential in borrowing costs will continue, its effects have had an impact on the behavior of various reserve measures. Since CDs have larger reserve requirements, a shift in bank liabilities into CDs and out of Eurodollars has resulted in an increase in bank reserves relative to total liabilities.

Moreover, since CDs are not included in the narrow monetary aggregates – M_{1a}, M_{1b}, or even M_2 – the growth of bank reserves and the monetary base has been faster relative to the growth in these monetary aggregates than would otherwise have been the case. And lagged reserve accounting implies that this effect on the growth in reserves relative to money supply growth may continue for at least two weeks–even if the borrowing cost differential disappears.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				June 4, 1980			
IMF mil-ollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
3	Government to receive $107 million in development aid from I.D.A.	Feb.	+18%	Jan.	+19%	—	.0650	Credit availability continues limited.	**Bangladesh**
8	Value of teak exports doubled in 1979 to $100 million.	Jan.	+ 3%	n.a.	—	—	.1510	Money supply grew 18% last year.	**Burma**
0	Volume of exports forecast to rise 11.5% in 1980, versus 26% in 1979.	n.a.	—	—	—	—	.7200	Bank of China to set up joint venture merchant bank.	**China, People's Republic**
—	First-quarter trade gap is 39% wider than year-earlier.	Mar.	+18%	Mar.	+43%	—	.2035	Prime rate decline buoys stock market.	**Hong Kong**
0	Crop failure necessitates import of 200,000 tons of sugar.	Feb.	+12%	Jan.	+23%	9.00%	.1290	Six largest private banks nationalized.	**India**
0	Rice imports to increase 40% this year.	Mar.	+21%	Nov.	+12%	—	.001630	Tax to be put on interest on foreign-currency time deposits.	**Indonesia**
0	Licensed imports in April were 68% greater than in April 1979.	Apr.	+ 8%	Feb.	+ 9%	9.00%	.004504	Long-term interest rates rise to 10.3%.	**Japan**
8	Current-account gap may hit $5 bn. this year, versus $3.9 bn. in 1979.	Mar.	+28%	Mar.	+41%	21.00%	.0018	Large foreign borrowings will boost money supply growth.	**Korea**
0	Government to impose 25% export tax on oil.	Mar.	+ 6%	Feb.	+15%	—	.4635	Prime rate holds steady at 7.5%.	**Malaysia**
11	Earnings from tourism increased 25% last year.	Jan.	+15%	Dec.	+23%	—	.0855	Large fiscal budget increases money supply growth.	**Nepal**
4	U.S. to provide trade concessions on textiles.	Mar.	+10%	Jan.	+24%	10.00%	.1020	Credit restrictions maintained.	**Pakistan**
9	Trade deficit reached $724 million in first quarter.	Apr.	+19%	Feb.	+24%	4.00%	.1365	Credit conditions continue restrictive.	**Philippines**
0	March trade deficit a record $349 million, owing to heavy imports.	Feb.	+ 9%	Dec.	+28%	—	.4685	Prime rate dips to 11.75% from 12%.	**Singapore**
7	Textile export growth threatened by possibility of foreign quotas.	Dec.	+15%	Nov.	+42%	10.00%	.0665	Credit restrictions maintained.	**Sri Lanka**
0	Foreign investment in Jan.-Apr. was 54% above year-earlier level.	Mar.	+17%	Feb.	+19%	14.00%	.0290	Money supply grew 13% in March.	**Taiwan**
28	Export target of $6.8 billion set for 1980.	Dec.	+15%	Oct.	+28%	14.00%	.0505	Credit conditions remain restrictive.	**Thailand**
1	Commodity exports remained strong in first quarter.	Dec.	+10%	Jan.	+16%	—	1.1470	Restrictive monetary policy maintained.	**Australia**
3	Overall payments deficit rose to $482 million in fiscal 1979/80 ended March.	Dec.	+17%	Mar.	+18%	13.00%	.9840	Bank deposit growth was 18% in fiscal 1979/80.	**New Zealand**

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World Interest Rates

market rates of June 4, 1980; bond yields as of May 30, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	11.83	17.00	14.00	9.50	7.50	15.00* penalty rate 18.00	10.00	3.00	9.00
Day-to-Day Money	9.75 June 5	15.00	15.50	13.65	12.3125	9.50	16.875*	11.25	5.00	12.875
Treasury Bills 91-day, Middle Rates	7.27	11.60	16.00	15.10	n. a.	n. a.	14.75* 92-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.00 finance paper	12.00 finance paper 15% tax w/h	14.76	13.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	11.80 15% tax w/h	16.3125	15.00 Certified	not traded	10.30	19.00*	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.31	11.80	13.69	10.44 20% tax w/h	12.86	8.34	15.08*	9.96	4.82	8.25
Industrial Bonds prime, long-term, new and old issues, average yield	11.05 Aa Industrials	12.25	14.39	13.95	13.87	8.53	15.04*	10.83	5.68	7.50
Bank Short-Term Rate to Best Borrowers (prime rate)	13.00	13.75	18.00	18.75	14.60	11.50	20.00*	13.00	5.50	9.25
Bank Time Deposits 3-month	8.50 Cert. of Dep.	12.00 Cert. of Dep	16.875	15.15	12.5625	10.05	10.75*	11.25 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.9375	no market	16.75	no market	12.50	9.50	no market	10.875	5.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8642	2.3170	.03500	.2417	.5620	.001202	.5113	.6055	.004495
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.45 *D*	6.70 *D*	5.15 *D*	2.50 *D*	.50 *P*	8.89 *D*	1.15 *D*	4.45 *P*	2.00 *D*

Eurodollar Deposits
(London, interbank, bid)
June 5

7-day	9.5625
1-month	9.75
3-month	9.75
6-month	9.75

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.81
U.S.-Canada Treasury Bills	−2.40
U.S.-Canada Finance Co. Paper	−2.14
Eurodollars-U.K. Local Auth. Deposits	− .12

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.375
Over 7 yrs.	11.125
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	8.875

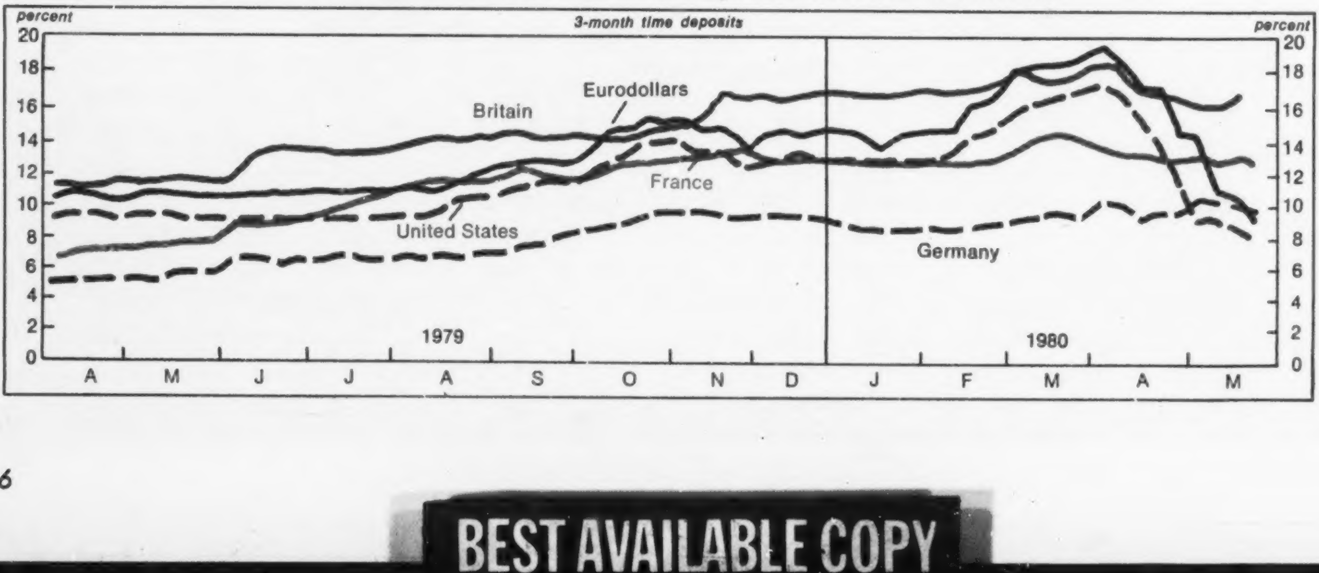
Gold Price

London
afternoon fixing

571.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of May 28; bond yields as of May 23.

Interest rate movements in major industrial countries



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Venezuela Poised for Steady Expansion

When Luis Herrera Campins assumed the presidency of Venezuela in March 1979, the country's fiscal and foreign-payments position was in considerable imbalance. The heavy government spending of the 1975-78 period, designed to speed up economic development and reduce dependence on oil, had adversely affected Venezuela's internal and external accounts. In 1978, the fiscal deficit approached 6% of GDP—a sharp contrast to the budget surpluses prevailing prior to 1977. Similarly, the current account of the balance of payments shifted from a surplus equal to 8% of GDP in 1975 to a deficit of 14% in 1978. The need to finance these deficits through external borrowing and reserve depletion expanded the Government's foreign debt burden from about $2 billion in 1975 to $14 billion at yearend 1978, while over the same period international reserves declined from $8.4 billion to $6.4 billion.

Since early 1979, however, the combination of sharp petroleum price increases and more conservative demand-management policies have arrested these deteriorating trends. And it appears as if this favorable combination of influences will continue to have a positive impact on the Venezuelan economy in the medium term.

Last year saw a shift to conservatism

On the fiscal front, progress toward a balanced budget was made last year largely by holding expenditures to their 1978 level of $11.5 billion, rather than through increases in income or sales taxes. This helped reduce the central government deficit to a low of 1% of GDP in 1979. In the last several months, government revenues have increased, owing to higher world oil prices, and it is estimated that the budget was brought into balance during the first half of 1980.

A restrictive monetary policy accompanied the conservative fiscal stance last year. The authorities slowed the growth of domestic liquidity to curtail the expansion of private demand and thereby reduce pressure on prices and imports. The growth of the monetary aggregates decelerated to rates of less than 10% during most of 1979 from rates in excess of 15% in the previous year. Indeed, during most of 1979, despite declining international reserves, the growth of domestic credit to the private sector was held at a rate no higher than that of 1977-78. In the past six months, however, the rise in oil export earnings has led to a renewed infusion of liquidity into the banking system. International reserves are currently $6.8 billion, up sharply from a low of $5.2 billion in August 1979.

An inevitable consequence of last year's contractive demand-management policies was a slowdown in the expansion of overall economic activity. Real GDP is estimated to have advanced about 3% in 1979, versus 4.8% in 1978. But even this expansion was mainly the result of a temporary increase in oil production, as non-petroleum sectors recorded either limited gains or actual declines in output. In the wake of the Iranian shortfall, Venezuela increased crude oil production by almost 9% to 2.36 million barrels per day.

Statistics for the first quarter of 1980 indicate that the economy continues to be depressed. Automobile and cement sales, reliable indicators of industrial and construction activity, dropped 17% and 6%, respectively, below their previous year's level. And petroleum production is also down—in contrast to its upsurge a year ago—currently standing at 2.1 million barrels per day, compared with 2.3 million in May 1979.

Despite the more restrictive fiscal and monetary stance, inflation accelerated in the last quarter of 1979. On a year-over-year basis, it reached 20.5% in December, compared with 7% a year earlier. The main cause was the removal of price controls on a large number of items, which was followed by legislated increases in salaries. In the first quarter of 1980, inflation remained around 22% on a year-over-year basis, but the monthly increments began decelerating because of the absence of additional cost-push factors.

A turnaround for the external accounts

Last year's restrictive policies and higher oil prices had a favorable impact on Venezuela's external accounts. Import expenditures remained at the same level as in 1978—$11 billion—which meant a substantial decline in real terms. On the export side, the oil shortage precipitated by the Iranian revolution set the stage for a sharp rise in the average price of Venezuelan oil from $12 per barrel in 1978 to more than $17 last year, and for a jump in the volume exported of 110,000 barrels daily to 2.1 million barrels per day. Consequently, export receipts soared 50% to $13.8 billion, and the trade balance, which posted deficits in 1977 and 1978, shifted to a surplus of $2.8 billion in 1979. Despite further deterioration in the services and transfers account, a result of higher interest payments on the larger external debt, the current-account deficit shrank from a peak of $5.4 billion in 1978 to $1.5 billion. Foreign borrowing by the private and public sectors—most of the external funds obtained by the Government and its agencies was short term—was sufficient not only to cover the current-account deficit, but also to allow for $1.3 billion in reserve accumulation.

Venezuela Poised for Steady Expansion *(continued from page 7)*

Venezuela's external payments position has continued to improve during the first half of 1980. Import demand has remained depressed, while export earnings have increased along with the rise in oil prices to their current weighted average of about $27 per barrel. In fact, it is estimated that the current account is now in surplus—for the first time since early 1976.

Oil windfall creates new options

Venezuela's balance-of-payments turnaround affords the authorities an opportunity to see through the completion of various projects begun by the previous administration and to address various unmet social needs. The uncompleted projects were launched by the Government after the 1973 oil price explosion, and were aimed at industrializing and diversifying the economy, achieving self-sufficiency, and improving export prospects. Most of the investments were concentrated in a few basic industries (e.g., steel and aluminum) as well as in infrastructure. (The oil sector did not benefit from the investment boom; indeed, insufficient exploration and a conservation objective were responsible for a cut in oil production from 3 million barrels per day in 1974 to 2.2 million by 1978.) However, shortages of skilled manpower and building materials, cost overruns, and instances of waste and corruption hindered the completion of several of the major projects.

While the new petroleum bonanza has essentially eliminated the need for haste in Venezuela's diversification effort, and has made available new funds for investment purposes, the Herrera Administration has decided to proceed cautiously. Emphasis will apparently be placed on curbing mismanagement within the public sector generally, and within the emerging industries in particular, as well as on investment in the petroleum industry and in low-income housing.

The renewed interest in the petroleum sector was reflected in a massive $25-billion, ten-year investment plan launched last year. The program's obectives are to increase productive capacity to 2.8 million barrels per day, locate more light and medium crudes, upgrade refinery capability to produce more gasoline, and develop the Orinoco Heavy Oil Belt into a commercially viable source of crude. At present, Venezuela possesses about 18 billion barrels of proven petroleum reserves, enough to sustain another 22 years of output.

The Herrera Government has also taken steps to stimulate private-sector investment. In recent years, the local business community has become increasingly uncompetitive because of the protection afforded by high tariffs and the absence of new foreign ventures in the country. Moreover, business has been hindered by an unfavorable investment climate attributable to government interference in pricing and in other management decisions.

It is in an effort to stimulate producers that the authorities lifted many price controls and began to open up domestic markets to external competition through tariff reform. The success of these measures hinges primarily on the Government's willingness to continue with its price decontrol program despite the inevitable short-run inflationary effects and the opposition from organized labor. The plan's favorable impact on resource allocation also depends on tariffs being lowered well below their current level of more than 100%.

Medium-term outlook

The improved external-payments and fiscal-revenue situation is likely to lead the Venezuelan authorities to pursue a more expansionary set of monetary and fiscal policies that will foster a reactivation of the economy. GDP growth may well begin accelerating during the second half of this year, with industry and construction leading the economic recovery. Only the petroleum sector is anticipated to register an absolute decline, as oil production will be kept at least 10% below last year's level.

The outlook for 1981-82 depends to a large extent on how rapidly the Venezuelan Government spends its second oil windfall. If social, regional, and other pressures are such that the authorities embark on a new spending spree, the result will be a high rate of economic growth accompanied by rapid inflation and a quick return to current-account deficits. If, on the other hand, the Government holds firm to its stated objectives of rejecting new ambitious industrialization projects, completing investment programs already under way, and providing greater incentives to private-sector capital formation, Venezuela's development will proceed at a less rapid, but more orderly, pace. This would mean real GDP growth averaging approximately 5% during 1981-82, and an inflation rate declining to the 10%-15% range. Since import demand will probably not rise at the excessively high rates of 1974-78, while oil prices will likely continue to increase in real terms, the country's current account should not register a deficit any larger than 2% of GDP by 1982. This would permit the Venezuelan authorities to reduce the burden of the country's external indebtedness both by minimizing its growth and by improving its maturity profile.

Nina Ramondelli

CHASE

International Finance

Vol. XV, No. 13
June 23, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

6/23/80 B1900-1 U

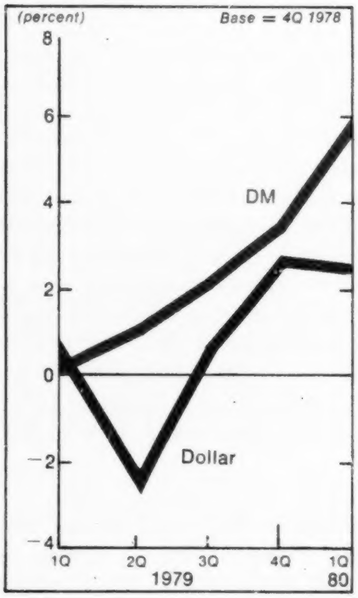
Sustained Franc Strength A Strong Possibility

The phenomenon of the strong French franc has perplexed foreign-exchange analysts for well over a year now. Despite a French economic performance that is far from inspiring, the franc stands firmly at the head of the European Monetary System, a position it has occupied since March.

Several indicators that serve as traditional barometers of a currency's future movement have persistently pointed in a downward direction. First, inflation in the first quarter averaged 16.2%, annualized, and is now rising at a year-over-year 14%. Second, the current account has shifted into substantial deficit after two years of surplus, with the deficit for the first quarter of the year estimated at 10 billion francs. Third, monetary growth continues strong, buoyed by high credit demand. The Government's objective of reducing M_2 growth from its current annual rate of 13% to 11% by yearend is likely to prove difficult to achieve. Despite these adverse elements, however, the franc has held firm.

Two factors appear particularly instrumental in buoying the French currency. The first is the fundamental shift in government policy associated with Prime Minister Raymond Barre. Barre has repeatedly espoused a program of austerity combined with liberal reforms. The Government has set restrictive monetary targets, has tightened credit controls progressively, and is determined to trim the budget deficit. Moreover, Barre has continually emphasized the central role that a firm exchange rate plays in French economic policy. Another factor favorable to the franc has been the relative weakness of the German mark. The mark's softness reflects a large current-account gap associated with Germany's recently buoyant economic growth.

Real appreciation of the franc against the dollar and DM



Whether the franc will remain a leading European currency in the second half of 1980 is a matter of some speculation. As the French economy moves into recession and unemployment increases, political pressure to reflate will mount. And given the outlook of no imminent change in German monetary policy, an easing of French interest rates would seriously undermine international confidence in the franc. Still, there are several major constraints to any relaxation of the present strong-franc policy. The chief factor is the approaching presidential election scheduled for next spring. As long as the fight against inflation remains a critical economic and political objective, the authorities are unlikely to risk any currency devaluation. And without a general realignment of EMS parities, French monetary policy will very likely be kept on its present course, thereby limiting the scope for any lowering of interest rates by yearend and pointing to a continuation of a firm franc exchange rate.

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German economy signaling a downturn.

The German economy is beginning to show signs of weakening, after a strong first quarter in which industrial output rose at a seasonally adjusted annual rate of 6.4% over fourth-quarter 1979. Provisional figures reveal that industrial production fell 1.6% in April, with industrial order volume declining 4.5%. The drop in orders was broadly based across industries, but not across markets—the value of domestic orders fell a real 7%, while foreign orders declined by only 1%. The weakening of domestic demand has been confirmed by a recent survey that reveals a sharp deterioration in the business climate. And although another recent survey of investment intentions suggests a 10% *rise* in the volume of manufacturing investment this year, experience has taught that intentions are not always an accurate forecaster of realized investment. With German inflation—now 6% year-over-year—eroding consumers' real incomes, a further weakening of consumer spending is expected. And if foreign demand turns down in late 1980, the currently high level of inventories would create serious problems for industry and contribute to a pronounced cyclical downturn in the economy in the latter part of the year.

Weak Spanish economy reflected in a declining peseta.

Spain's current economic problems of rising unemployment, continuing inflation, and a deteriorating balance of payments have created problems for the center-right coalition Government of Adolfo Suarez. It recently survived a no-confidence vote in Parliament by only a narrow margin. A televised debate highlighted the country's problems, but no economic policy changes have been announced, nor are any expected to be. Monetary policy remains accommodating, despite rumors of renewed tightening in view of large budget deficits in the first few months of 1980. (Improved income tax receipts and an easing of private-sector credit demand, however, reportedly led to reduced monetary growth in April.) The peseta's exchange value has declined steadily since May 1979; it is expected to continue to decline moderately throughout 1980 as oil prices rise further and because tourist revenues are likely to be weak this season. Nevertheless, little currency intervention is expected by the Bank of Spain. Meanwhile, French opposition to Spanish membership in the European Community could postpone Spain's entry date beyond the presently scheduled early-1983.

Irish trade balance improves, but at a high cost.

Ireland's 1980 budget, introduced in February, reduced public expenditure and increased taxes largely to contain the country's widening trade deficit. The budget achieved its objective to some extent, for the trade deficit has narrowed steadily from January's huge gap of 204 million Irish pounds to £95 million in April. But the improvement in the trade balance still leaves the country with a deficit of 560 million pounds for the first four months of the year, versus £482 million for the same period in 1979 and 234 million pounds for January-April 1978. In addition, the deflationary impact of the budget is becoming clearer; most forecasters see less than 1% GDP growth for 1980. Unemployment has risen steeply, reaching its highest level at end-May since the winter of 1978—slightly over 9%. Tax increases have pushed up the cost of living, and the February consumer price index stood at 15½% above its year-earlier level, with the May figure expected to approach 20%. Thus, the country faces a long and difficult period of economic adjustment before any return to the rapid growth of the 1970s can be achieved.

Indonesian economic outlook uniquely bright.

The economic outlook for Indonesia is far brighter than most in the world. Rapidly rising oil and gas revenues, favorable world prices for tin, rubber, and lumber exports, and a burgeoning manufacturing export sector tied to cement, textiles, and electronics will give Indonesia a balance-of-payments surplus of over $2 billion for the current fiscal year ending March 1981. Overall, real GNP growth is expected to be a strong 7%. The country's foreign-exchange reserves, less than $600 million in 1975, will probably exceed $6.5 billion this fiscal year, an improvement of more than tenfold in just five years. Given the bullish world price outlook for oil and domestic production projections, substantial payments surpluses appear virtually certain, at least through the first half of the 1980s. Accordingly, financial indicators such as the debt-service ratio should continue to improve markedly. Indonesia is now exploring ways of stepping up expenditures to speed up the pace of economic development, and is expected to take advantage of its favorable international credit standing to obtain additional loans and spur foreign investment. Indonesia's goal is to broaden its industrial base, mainly in primary commodities processing, and thereby improve its long-term payments outlook.

Japanese inflation to ease toward yearend.

The year-over-year increase in Japanese consumer price inflation reached 8.4% in April, compared with an average rate of 3.6% in 1979. The roots of the present inflation lie in the expansionary monetary policy pursued in late 1978 and early 1979, combined with the sharp rise in import prices—mainly of oil and raw materials. As the 21.1% increase in wholesale prices in the first quarter implies, the consumer inflation rate is likely to climb into double digits for a brief period this summer before it begins to decline later in the year. While Japanese consumer price increases reflect some of the rise in wholesale prices, the recent slowing of the monetary aggregates, weakening consumer demand, stabilization of import prices, conservative wage increases, and productivity gains should work to moderate the rise in consumer prices. Moreover, the present commitment to anti-inflationary policies is not expected to change significantly following the June 22 elections and the installation of a new government.

Yugoslav political succession complete; attention now focused on economic adjustment.

Yugoslavia's political leaders have managed the post-Tito succession process with considerable skill. They have also begun to address the country's serious economic problems of excessive investment spending, high inflation, and a large balance-of-payments deficit. The Yugoslav domestic inflation rate has exceeded 25% since early 1979, while the balance-of-payments gap widened to $3.7 billion last year. In response to these problems, the National Bank of Yugoslavia announced a 30% devaluation in the second week of June, setting a new exchange level of 27.30 dinars to the U.S. dollar. After the appropriate rise in the prices of imported commodities, domestic prices will be frozen for a short period. Moreover, earlier in the year, major restrictions were imposed on the growth of personal incomes, enterprise credit, and capital investment. Western commercial banks continue to be an important source of liquidity. Net indebtedness to Western banks increased $2.7 billion last year, reaching a level of $5.5 billion at yearend; additional commercial borrowing is expected in 1980 as the adjustment process proceeds. In support of the Yugoslav economic stabilization program, the IMF has approved a standby arrangement that authorizes drawings of up to $430 million during 1980 and 1981.

Energy export revenues underpin Algerian economic improvement.

The sharp rise in oil prices since mid-1979 has led to a significant turnaround in Algeria's economy. The country's current account was in balance last year after posting a $3.5-billion deficit in 1978, and estimates for 1980 suggest a surplus of about $1.5 billion. The surge in export revenues—projected to total $14 billion this year—reduced 1979 Eurodollar borrowings by about one-third from their 1978 level, and have trimmed the debt-service ratio from 25% in 1978 to 22%. The likelihood of continued strong energy export earnings remains high, especially with Algeria being hawkish on price boosts. Prior to the recent OPEC meeting in Algiers, Algerian crude fetched $38.21 per barrel (including a $3 exploration surcharge), the highest in OPEC. Moreover, gas shipments to the United States and France have virtually ceased while efforts are made to more than double gas prices to align them with those for oil. The increased revenues will be channeled in a somewhat different manner. The country's new president has altered the direction of development policy by de-emphasizing heavy industry and giving greater priority to agricultural and social investment.

The High Cost of U.S. Oil Policy Failure

Two recent events underscore the problems faced by the United States in overcoming its excessive dependence on imported oil. First, Congress rescinded President Carter's authority to impose an oil import fee and overrode his subsequent veto. Second, the Organization of Petroleum Exporting Countries implemented additional price increases, despite high inventories of crude oil and refined products in the United States and elsewhere. The latest boost in oil import prices—the average per barrel cost to refiners of imported crude is now about $35, versus $15 at the beginning of 1979—will contribute to doubling the U.S. import bill to $85 billion this year from $42 billion in 1978.

As recently as 1969, only 25% of the United States' total oil supply was imported. Last year, by contrast, oil imports accounted for 45% of supply. But contrary to the notion that it is the monopoly power of OPEC that has led to this increased dependence, it could not have occurred without a series of U.S. Government actions that played directly into the hands of OPEC.

A heightened concern about U.S. dependence on foreign oil occurred in two earlier periods. In the early 1920s, imports accounted for about 20% of total crude supply. However, rapidly rising domestic production during the rest of the decade reduced dependence to about 10%. From 1930 to 1946, imports averaged about 6½% of crude supply. But the energy needs of a growing post-war economy outstripped the domestic oil industry's capacity to increase production. By 1957, the import share had climbed to 18%, leading then-President Eisenhower to exhort importers to voluntarily limit the quantity of foreign crude. The appeal for voluntary restraint failed, however, and a mandatory oil-import quota program that restricted the market share of imported oil was instituted in 1959.

Rapid economic growth in the 1960s led to sharp increases in the quantity of oil demanded, which was largely satisfied by an increase of nearly 30% in domestic production. But rising domestic output also allowed the volume of imports to increase equally rapidly—so long as it maintained a fairly constant market share of 12%-15%. Moreover, imports of exempted refined products grew even more rapidly.

The low cost of foreign oil served to limit domestic prices. The wholesale price of domestic crude oil declined by 5% relative to other industrial commodities between 1959 and 1969, and the relative retail price of refined petroleum products such as gasoline dropped 7½% over the same period.

The falling real price of oil and refined products dampened U.S. oil producers' incentive to explore for new sources. The number of wells drilled declined by 40% between 1959 and 1969. As a result, new additions to proven oil reserves fell below the level of domestic production. Proven domestic reserves in

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE			
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	First-quarter real GDP growth was 3.6%, annualized, paced by construction and investment activity.	Mar.	+ 32%	102.1	$3,825	Feb.	9,730	+ 78%	24.9
Bahamas	Higher oil costs and aggregate demand pressures boosting the price level.	Dec.	+ 18%	1.0	4,000	Apr.	102	0	2.1
Brazil	Inflation rate reaches record 95% in May; Government continues efforts at price stabilization.	Apr.	+ 31%	209.1	1,760	Feb.	7,703	— 32%	4.5
Chile	Price controls lifted on several items; inflation in first quarter roughly the same as in 1979.	Feb.	+ 70%	19.0	1,710	Apr.	2,277	+ 51%	6.5
Colombia	Major effort under way to develop domestic energy resources; coal and natural gas show most promise.	Apr.	+ 44%	28.7	1,100	Apr.	4,121	+ 57%	10.8
Costa Rica	Economic slowdown expected in view of more restrictive fiscal and monetary policies.	Jan.	+ 20%	3.9	1,790	Apr.	81	— 50%	0.7
Ecuador	Potential conflict between President and Congress resolved for the time being.	Apr.	+ 45%	8.7	1,070	Apr.	830	+ 23%	5.2
El Salvador	Political upheaval having severe repercussions on domestic economic activity.	Dec.	+ 3%	3.4	760	Apr.	102	— 64%	1.2
Guatemala	Central bank provides emergency $60-million line of credit to financially strapped private sector.	Dec.	+ 9%	7.2	1,060	Apr.	654	— 20%	5.5
Guyana	Rice, sugar, and bauxite output rates recovering from strike-induced declines of last year.	Dec.	— 2%	0.5	625	Dec.	9	— 84%	0.3
Honduras	Economic expansion continues brisk; opposition party wins majority votes in assembly elections.	Sept.	+ 34%	1.9	540	Jan.	208	+ 14%	3.3
Jamaica	Massive, five-year expansion plan announced for bauxite/alumina industry; alumina output up 7%.	Nov.	+ 4%	2.7	1,230	Mar.	89	+ 16%	1.1
Mexico	Investment spending and employment gaining strongly, but inflationary pressures also intensifying.	Jan.	+ 52%	117.9	1,700	Jan.	2,218	+ 13%	2.2
Nicaragua	Economic recovery proceeding slowly; reconstruction effort hindered by insufficient financing.	Oct.	— 52%	1.7	660	Nov.	85	+ 42%	2.9
Panama	Government making progress toward limiting fiscal deficit through spending curbs and taxing effort.	Dec.	+ 71%	2.7	1,420	Mar.	90	— 55%	1.0
Peru	Increased activity in mining, oil, and manufacturing may boost economic growth to 5% this year.	Dec.	+129%	12.1	700	Mar.	1,510	+274%	12.0
Uruguay	Standby program with IMF aimed at slowing inflation and further liberalizing foreign trade.	Dec.	0	7.2	2,500	Feb.	441	+ 18%	4.5
Venezuela	Economy continues depressed; auto and cement sales down 17% and 6%, respectively, in first quarter.	Jan.	+ 56%	46.1	3,385	Mar.	6,296	+ 21%	6.7

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absolute terms dropped by almost 7% between 1959 and 1969, constraining subsequent output further.

The rise in the foreign share of U.S. oil supply from 18% to 25% between 1959 and 1969, and the concomitant decline in domestic reserves, should have brought forth effective Federal policies to encourage conservation and domestic exploration. This could have been accomplished through higher prices and/or more severe restrictions on imports, perhaps via the auction of import licenses. Unfortunately, however, no such steps were taken.

As the quantity of oil demanded continued to grow in the early 1970s, while domestic production declined, the U.S. Government permitted oil imports to skyrocket to 40% of supply. And relative prices of crude oil and oil products were allowed to fall further, albeit at a slowing rate. The United States was suddenly struck with the high price of its dependence in the winter of 1973-74, when a partial OPEC embargo and the quadrupling of imported oil prices aggravated inflation and the recession then under way.

The U.S. adjustment to higher oil prices then began. It was however, hampered by price controls on domestic crude oil and gasoline. Nonetheless, conservation efforts launched then were successful in slowing the growth rate of energy use relative to total economic growth. But since domestic oil production has shown virtually *no* increase in the last five years, whatever economic growth that has occurred has resulted in further deterioration in the import ratio. By 1977-78, imported oil accounted for about 50% of supply. Shortly thereafter, in 1979-80, the U.S. economy was dealt another blow as OPEC prices were boosted sharply.

In contrast to the counterproductive policy of price controls following the 1973-74 round of OPEC price rises, however, the sharp increases in early 1979 were accompanied by the start of a phased decontrol of U.S. crude oil and gasoline prices. Consumption then began responding to higher prices. Gasoline demand is now about 10% lower than a year ago, and oil imports currently constitute "only" 41% of supply.

Yet one cannot but wonder how the decade of the 1970s might have looked if the United States had launched a more responsible oil policy sooner, and indeed a more effective overall energy policy. The U.S. remains saddled with a high level of imports and high prices. Had the country accepted higher prices sooner, imports would certainly have been lower, and the pricing power of OPEC might have been significantly reduced.

The United States consumes about one-third of the non-Communist oil supply. Consequently, U.S. consumption has a disproportionate impact on world prices, so U.S. responsibility to formulate effective policy is substantial. Some of this responsibility will be discharged when U.S. crude oil prices reach world levels in September 1981, but oil products will still be much cheaper than elsewhere because of lower taxes. Thus, stronger U.S. measures to bring domestic supply and demand into better balance are critical if price hikes are to be curbed in the future. *Douglas L. Bendt*

F PAYMENTS		MONEY AND BANKING							
e of IMF dit, mil- of dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	domestic credit	central bank rate June 18, 1980	exchange rate in U.S. dollars June 18, 1980	current monetary conditions	COUNTRIES
0	Rapid import growth produces first-quarter trade deficit.	May	+115%	Jan.	+160%	—	.00060	Short-term interest rates rise.	**Argentina**
0	Tourism sector shows strong earnings.	Feb.	+ 12%	Dec.	+ 7%	—	1.01	Bahamian dollars limited in availability.	**Bahamas**
0	Small trade surplus posted in May.	May	+ 95%	Mar.	+ 69%	33.00%	.0205	New tax boosts cruzeiro borrowing costs.	**Brazil**
60	Ban on foreign-currency loans lifted; limit on banks' external debt removed.	Apr.	+ 39%	Aug.	+ 48%	—	.0270	Rapid growth in banks' net international assets.	**Chile**
0	Higher coffee prices boost export earnings.	Feb.	+ 26%	Apr.	+ 21%	30.00%	.0240	Money restraints eased somewhat.	**Colombia**
74	External payments position remains weak.	Jan.	+ 15%	Jan.	+ 40%	8.00%	.1200	Credit growth curbed.	**Costa Rica**
0	Larger trade surplus posted, owing to oil exports.	Mar.	+ 13%	Nov.	+ 43%	8.00%	.0370	Some restrictions placed on domestic lending.	**Ecuador**
0	Exports not likely to drop much from 1978 level.	Aug.	+ 7%	Jan.	+ 31%	—	.4030	New credit lines opened to export producers.	**El Salvador**
0	Foreign-exchange controls imposed; profit remittances abroad not affected.	Mar.	+ 11%	Jan.	+ 28%	—	Par	Liquidity is tight.	**Guatemala**
57	Higher oil prices boost import costs.	Dec.	+ 18%	Dec.	+ 27%	10.50%	.4000	Bank reserves decline.	**Guyana**
21	Banana exports should reach $200 million in 1980.	Sept.	+ 9%	Jan.	+ 14%	4.00%	.5010	Lending rates increased.	**Honduras**
43	Banks agree to month-to-month deferral of principal repayment on debt.	Dec.	+ 18%	Jan.	+ 22%	11.00%	.5800	Further decline in net international assets.	**Jamaica**
37	Oil export markets being diversified.	Feb.	+ 23%	Dec.	+ 31%	4.50%	.0450	Higher interest rates attract increased deposits.	**Mexico**
56	Debt rescheduling negotiations with commercial banks continue.	Dec.	+ 63%	Aug.	+ 56%	—	n.a.	Net international reserves are low.	**Nicaragua**
38	Large increase in Colon Free Zone earnings.	Feb.	+ 14%	Dec.	+ 23%	—	Par	Rapid growth of banking sector.	**Panama**
04	Surcharge on imports annulled; licensing need for certain items abolished.	Mar.	+ 60%	Oct.	+ 29%	29.50%	.0040	Increase in short-term rates.	**Peru**
0	Tourism earnings rise sharply.	Mar.	+ 78%	Dec.	+110%	—	.1175	Heavy inflows of external funds into banks.	**Uruguay**
0	Import demand weak during first half, while export earnings continued rising.	Mar.	+ 22%	Jan.	+ 5%	12.00%	.2335	Net international reserves rising.	**Venezuela**

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World Interest Rates

market rates of June 18, 1980; bond yields as of June 13, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	11.29	17.00	14.00	9.50	7.50	15.00 penalty rate 18.00	10.00	3.00	9.00
Day-to-Day Money	9.375 June 19	15.00	15.75	12.40	12.875	10.10	16.875	11.00	5.50	12.6875
Treasury Bills 91-day, Middle Rates	6.86	10.50	15.5625	14.50	n. a.	n. a.	14.60 73-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	7.50 finance paper	11.10 finance paper 15% tax w/h	14.44	13.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.00	11.00 15% tax w/h	15.75	14.50 Certified	not traded	9.90	19.00	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.49	11.31	13.58	10.38 20% tax w/h	12.96	8.15	15.14	9.93	4.77	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	10.75 Aa Industrials	11.90	14.27	14.11	13.86	8.29	15.15	10.77	5.70	7.40
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	18.00	18.25	14.60	11.50	20.00	13.00	5.50	9.25
Bank Time Deposits 3-month	7.875 Cert. of Dep.	11.00 Cert. of Dep	16.50	14.05	12.5625	9.85	10.75	10.75 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.00	no market	16.75	no market	12.625	9.3125	no market	10.5625	5.5625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8682	2.3290	.03542	.2435	.5672	.001199	.5175	.6161	.004638
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.27 *P*	7.55 *D*	5.18 *D*	3.75 *D*	.35 *D*	10.26 *D*	1.70 *D*	2.85 *D*	1.12 *P*

Eurodollar Deposits

(London, interbank, bid)
June 19

7-day	**8.9375**
1-month	**9.125**
3-month	**9.25**
6-month	**9.3125**

International Arbitrage

(3-month, hedged) ***+ in favor of U.S. dollars***

U.S.-U.K. Treasury Bills	**– .94**
U.S.-Canada Treasury Bills	**–6.50**
U.S.-Canada Finance Co. Paper	**–6.72**
Eurodollars-U.K. Local Auth. Deposits	**– .20**

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**10.50**
Over 7 yrs.	**11.00**
DM Bonds	
7 yrs. and under	**8.25**
Over 7 yrs.	**8.25**

Gold Price

London
afternoon fixing

602.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.7 (Apr.)	9.4 (May)	21.9 (May)	13.9 (Apr.)	6.1 (May)	20.7 (Mar.)	4.3 (May)	8.4 (Apr.)
Industrial production*	−4.7 (May)	−1.3 (Mar.)	−4.8 (Apr.)	4.6 (Apr.)	4.1 (Apr.)	14.9 (Apr.)	4.0 (Dec.)	10.0 (Apr.)
Trade balance† ***(billions of local currency units)***	−$1.87 (Apr.)	−C$.007 (Apr.)	−£.018 (May)	−FF7.75 (May)	DM1.1 (Apr.)	−Lit.1,510 (Apr.)	−SF1.26 (Apr.)	−¥490 (Apr.)
Money supply (M_1)*	4.1 (May)	6.1 (Apr.)	2.5 (Apr.)	8.7 (Feb.)	−1.1 (Feb.)	22.4 (Nov.)	−14.8 (Mar.)	7.0 (Mar.)
Velocity of money (M_1)*	2.7 (Mar.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	−0.2 (Sept.)	n. a.	3.8 (Dec.)
Reserves minus gold ***($ million, change from previous month)***	74 (Apr.)	274 (Apr.)	1,833 (Apr.)	4,334 (Apr.)	1,938 (Apr.)	3,629 (Apr.)	−645 (Apr.)	3,629 (Apr.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

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New Legislation Challenges Banks

The following is based on a recent speech given by **Richard C. Aspinwall,** *Vice President and Director of Banking and Financial Market Research, the Economics Group of The Chase Manhattan Bank, before the Bank Marketing Association.*

The new banking legislation enacted in March points to major changes in bank markets. The main issue is not whether change will occur, or even when, but how much. The bill—the Depository Institutions Deregulation and Monetary Control Act (the "omnibus" banking bill)—significantly broadens the asset and liability powers of thrift institutions. It also creates a vehicle for eliminating certain deposit ceiling rates; authorizes consumer NOW accounts for all banks and thrifts; and provides new schedules of reserve requirements for most depository institutions. The adjustments that these changes portend for banks are coming at a time when bank intermediation generally is being subjected both to greater risks from the effects of inflation and to increased pressures on profit margins stemming from a wide variety of competitive forces.

Overview of banking legislation and regulation

I shall turn to specific banking implications of the new omnibus bill shortly. But first it is useful to delineate some general themes relating to banking legislation and regulation.

First, responses to changes in economic and financial conditions constitute the major dynamic forces that shape strategies of bank management. Here are several examples of recent changes in conditions: (1) higher and more variable inflation; (2) higher and more volatile rates of interest; (3) rising reliance by business and individuals on debt to sustain spending; and (4) the greater institutionalization of saving (e.g., through pension and profit-sharing arrangements).

These factors have been reflected in a variety of changes in banking practices. First, bank customers are exercising tighter control over their liquid assets. Second, banks are resorting more to funding liabilities on which market-based interest rates are paid. For example, the share of bank assets represented by such liabilities rose from 18% in 1972 to almost 40% in 1979. Third, there is a strong tendency (e.g., in mortgage lending) to seek closer linkage between returns on loans and funding costs. Fourth, nondeposit entities are becoming more aggressive in a number of banking functions, especially those where regulatory restrictions have imposed major constraints on banks' operating efficiency. Expanded business reliance on the commercial paper market is one such example. Finally, thrift institutions have responded to some of these same dynamic forces by broadening their range of financial services.

My second point is that changes in banking legislation and regulation tend to be lagging, not leading, influences. They validate or legitimize, but do not normally innovate (except inadvertently). The NOW account development, which began in New England, is a good example.

My third point is that, as a reform measure, the new banking bill is seriously deficient in several respects. Its deficiencies are likely to impose continuing problems for banks (and other depository institutions) and their customers. First, the bill does not provide for the elimination of the prohibition against interest on demand deposits. This prohibition has encouraged a wide variety of operating inefficiencies. It has also contributed to inadequacies in the machinery of monetary control. Nor does the legislation fully eliminate usury ceilings. Second, there is no provision for removing present constraints on interstate expansion by branches or holding-company affiliate banks. Third, important restrictions now imposed under Glass Steagall—for example, those aimed at commingled investment accounts—are not addressed.

And finally, despite the Congressional provision that Regulation Q be eliminated over the next six years, such an outcome is highly uncertain. To be specific, the new banking bill vests authority to set deposit interest rates with a Deregulation Committee. For one thing, the Committee may feel its latitude is constrained by the fact that old, low-yielding, fixed-rate mortgages will impose a drag on earnings for some time to come. Moreover, Congress has not directly addressed the issue of ceiling differentials between banks and thrifts. Differentials could remain in force as long there are ceilings per se. Politically, this may serve to sustain ceilings. And furthermore, the Committee has not been especially aggressive in providing for deregulation so far. For example, it has embraced *new* restrictions on premiums as promotional devices, finders fees, and early withdrawal penalties. In short, those anticipating a Q-free environment six years from now had better hedge their bets.

Banking implications of the omnibus banking bill

Given the dynamic influences affecting financial markets, here are the major banking implications that I believe stem from the omnibus bill:

1. *Thrift Competition.* The bill authorizes interest-bearing personal checking accounts on a nationwide basis for banks and thrifts. In addition, it provides

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that Federal savings and loan associations may invest up to 20% of their assets in a combination of consumer loans, commercial paper, and corporate debt securities. While it may appear small, the 20% maximum seems to offer ample latitude for vigorous entry by those institutions finding these markets attractive. Indeed, as a starting point, the 20% figure is not substantially out of line with many *banks'* present positions. For all commercial banks (as of December 1978), commercial and industrial loans were only 17½% of their total assets and consumer credit was less than 15%. For the largest banks (assets of $5 billion or more), the proportions were about 22% and 8%, respectively.

So as a means of strengthening their positions as sources of individuals' financial services, it seems highly likely that thrift institutions will seek to expand aggressively into transactions services and consumer credit. And they will also look to some business lending. In connection with product extension, however, there is some question about the means thrifts will employ to expand retail presence. Even if desired, an enhanced branching network cannot be established quickly (e.g., it takes time to build and staff branches, and many good sites are already taken). Methods to counter short-run network handicaps will include emphasis on remote transacting facilities, aggressive pricing and promotion, more liberal terms of service (including credit terms), and product innovation. Such efforts clearly point to the prospect that this new competition will speed the obsolescence of traditional bricks-and-mortar branching. And the institutional population itself is likely to undergo significant change.

2. *Deposit Pricing.* As I have already suggested, it is far from certain that Regulation Q will be effectively eliminated within six years. Assuming market interest rates fall toward (and possibly below) ceilings on a reasonably wide scale during the next year, the acid test of the Deregulation Committee's resolve is near at hand. Provision for ceiling elimination is most easily accomplished when existing ceilings are not binding. Later on, when market rates again rise well above whatever ceiling levels remain, strong political pressures against substantive action are likely to develop. Failure to eliminate ceilings will mean that an increasing share of retail financial services will move outside depository institutions in the future. Unregulated alternatives are readily available.

Assuming the Regulation Q phase-out proceeds, banks will have to apply more rigorous techniques of asset and liability management to retail funding. This will be more of a learning process for smaller banks than larger ones. In the past, retail deposit pricing was largely (although not entirely) a function of applicable Regulation Q ceilings.

3. *Reserve Requirements and Related Matters.* The omnibus bill establishes an 8%-14% range (with 12% the initial rate) for reserve requirements on all transactions accounts totaling over $25 million at banks and other depository institutions. Reserve requirements on personal time deposits are eliminated. And a range of 0-9% (initially 3%) is established for nonpersonal time deposits. The new bill also requires the explicit pricing of Federal Reserve operating services, including the value of float, and this action is likely to encourage more efficient operating practices.

In terms of marketing strategies, what must be emphasized is that reserve requirements such as these are a tax. The opportunity cost represented by these reserves is a cost to banks and ultimately to their customers. It is not a tax that is imposed on nondeposit institutions. Consequently, it entails a competitive disadvantage for those subjected. It will thus ensure that further amounts of banks' business may shift to those entities and transactions not subject to the tax. Indeed, under this legislation, deposit institutions are exposed to the risk of becoming chiefly switching points for transfers of liquid assets that are increasingly outside the deposit system. As with demand deposits generally, the payment of explicit interest on reserve balances would largely eliminate the inefficient and disruptive efforts encouraged by the reserve-requirement tax.

Conclusion

In a narrow sense, the initial competitive impacts of the omnibus bill will tend to be more oriented to "retail", rather than "wholesale", banking. The former has been more heavily regulated, of course. But over the longer run, all banking markets face substantial changes in pricing, delivery of services, and numbers of competing institutions.

The new competition encouraged by this legislation will be only one aspect, however, of dynamic change in markets for financial services. More forceful participation by nondeposit entities is also an increasingly potent force. But in the final analysis, the greatest unknown will be the effects of future economic conditions on intermediation. As we have seen, more volatile economic conditions have meant increasing financing risks and uncertainties. These greater risks and uncertainties must be contained or serious problems—and possibly disruptions—lie ahead in the 1980s.

CHASE

International Finance

Vol. XV, No. 14
July 7, 1980

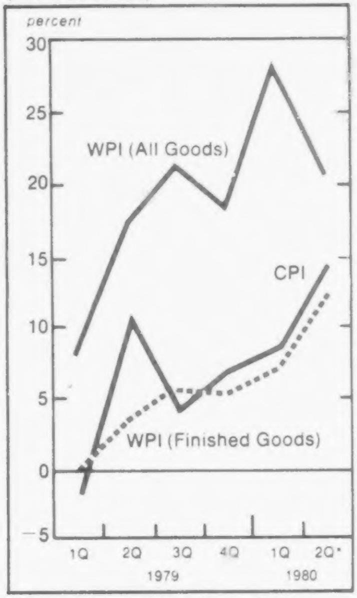
Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

7/8/80 E 1900-1 U

The Outlook for Inflation in Japan

Inflation is now hitting the Japanese consumer with a vengeance. Although wholesale prices accelerated sharply in early 1979 following the first round of OPEC price hikes, consumer prices lagged well behind. As late as last November the Japanese consumer price index was up less than 5% on a year-over-year basis, while wholesale price increases were well into the double-digit range. Since then consumer prices—as well as wholesale prices—have climbed rapidly. Wholesale price inflation appears to have peaked in April—with the overall index up 24% above the level of April 1979—and is now abating. The peak in consumer price inflation is yet to come, however. In May the consumer price index stood more than 8% above the level of a year ago. By August the year-over-year rate of increase of consumer prices should reach 11%. And the inflationary momentum already built into the price structure implies that consumer price inflation is unlikely to fall below the double-digit level on a year-over-year basis before early 1981.

Japanese inflation rates
(Quarterly average price rises over preceding quarter, annualized)



*Estimate based on data through May

This inflation outlook is obviously bad news. Nonetheless, there is a message hidden in the numbers that can be of some cheer to the Japanese policymakers. The inflation thus far is mainly imported rather than homegrown. And the combination of wage restraints, high productivity growth, and fiscal-monetary tightness will moderate imported inflation. Thus, the indirect or secondary effects of the OPEC price actions on domestic inflation should be felt less severely in Japan than in most other industrialized countries. The spring wage offensive settled for a surprisingly moderate 6½-7% increase in wage rates. And although productivity growth in manufacturing in unlikely to match last year's 12% increase, it will continue at a relatively high rate. Between now and yearend the rate of wholesale price inflation in Japan should fall sharply, even if the yen does not strengthen significantly from its current level.

Barring another quantum leap in the price of oil, this downward trend in wholesale price inflation in Japan should continue well into 1981. And if it is further assumed that there will be no significant relaxation of monetary policy, the pace of consumer inflation should decelerate noticeably in the first half of next year. Thus, while the consumer price index in fiscal-year 1980 (April 1980-March 1981) will probably average roughly 10% higher than in fiscal 1979, the rate of inflation facing the Japanese consumer could fall back to moderate levels in fiscal 1981.

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Canadian GNP declined in the first quarter.

The Canadian recession is now confirmed. Statistics indicate an annualized drop in real GNP of 2% during the first quarter. The drop was mainly the result of declines in residential construction and exports, as well as weak consumption spending and the deepening U.S. recession. Bolstering the economy against an even larger decline has been the Government's deficit spending, in addition to the large reserve of personal saving that is helping to support consumer spending. The quick downturn has helped contain inflationary pressures. The rate of inflation has been held below 9.5%, while the fall in output has produced a moderate increase in unemployment from 7.3% to 7.8% between December and May. These trends suggest a mild economic downswing over the course of the recession.

Portuguese authorities encouraged in anti-inflation battle.

As Portugal moves toward general elections in October, the importance of economic issues is mounting. The center-right Carneiro Government, in power since December, has pledged to reduce inflation from its 1979 rate of more than 24% to under 20%. It appears that the goal will be attained, following a 6% revaluation of the escudo in January, along with higher subsidies for basic commodities. Most recent reports peg the year-over-year inflation rate at 19.6% and falling. This has encouraged the authorities to reduce the monthly crawling-peg devaluation to 0.5% from 0.75%, which should lower inflation further. In the meantime, however, the labor unions have fomented industrial unrest on several occasions, clamoring for increased wages. And longer-term prospects have been clouded by recent French opposition to the enlargement of the European Community. Portugal had hoped to complete negotiations and begin receiving substantial EEC aid in 1981, prior to its entry at the beginning of 1983. French objections may now delay the timetable slightly.

Turkey obtains IMF standby, commits itself to economic restructuring.

The recently approved $1.65-billion IMF standby loan marks the IMF's approval of the new Turkish Government's economic policies. It also implies continued relative economic austerity over the next three years. The country's recent economic performance has been far from encouraging. Real GDP showed virtually no growth last year, and April inflation rose to a year-over-year rate of 117%. On the external front, January-April exports in dollar terms rose an estimated 7.3%, to an annual rate of $2.7 billion, while imports advanced 6.1% to an annual rate of $5 billion. The current account is now expected to register a deficit of at least $3 billion this year. More encouraging is the Government's commitment to freeing interest rates to boost savings, reducing subsidies to state economic enterprises, and limiting the growth of the central bank's net domestic assets. Any economic restructuring, however, will take time, and Turkey's heavy debt-service burden, energy dependence, and the import-intensity of its industry ensure that it will continue to require large amounts of foreign assistance over the next three years.

Despite lower oil output, Iran posted a large current-account surplus in 1979.

The Iranian current account posted a surplus of approximately $11.5 billion in 1979, compared with a near-balance position in 1978. This marked improvement occurred despite a 42% drop in oil output from an average 5.2 million barrels per day in 1978 to 3.1 million bpd last year. It was essentially the result of two developments: higher oil prices and reduced imports. The average oil export price (including spot-market sales) soared 84% from $12.65 per barrel in 1978 to an estimated $23.30 per barrel last year, bringing total oil revenue to $20.5 billion in 1979, just about the same as in 1978. At the same time, purchases from abroad fell off sharply. Merchandise imports declined to approximately $8 billon from $18.5 billion in 1978. This year, the current-account surplus will be relatively small, at best. With the loss of Japanese and several European customers, Iran's exports of crude oil and refined products have fallen to a current level of some 800,000 barrels per day. Official prices have been maintained at the average level of $34.87 per barrel (including premiums) since April 1, with some discounting reported. If Iran sustains its present prices and boosts exports to an average one million barrels per day for the year, while holding average imports to no more than $9 billion, it will post a current-account surplus of $1.5 billion in 1980. This would be insufficient to cover current budget needs and would require a large drawdown of international reserves, which stood at $14.7 billion in January.

Norwegian authorities under increasing pressure to alter policies.

Huge oil reserves and a small population make Norway's long-run economic prospects highly favorable. Indeed, this year's oil production will be sufficient to give Norway a current-account surplus in 1980, while every other European nation will likely post a deficit. Nonetheless, short-term problems exist. Inflation, which averaged 4.8% last year, has accelerated steadily, reaching 9.4% in May and promising a double-digit average for 1980. The resultant reduction in competitiveness threatens Norway's export industries, and the non-oil sector is expected to show almost no growth over the next 18 months. Consequently, pressure is mounting for a change in government policy. In this context, the Norwegian Federation of Industry has accused the authorities of expanding the public sector's role at the expense of private economic activity. It is calling for a tighter budget in 1981 and a freeze on public-sector employment.

Brazilian exports strong, but greater import restraint is vital.

After a string of monthly trade deficits so far this year, Brazil posted a merchandise surplus in May, the first monthly surplus since 1978. The trade account was in the black by a total of $10.5 million for the month, with exports of $1.94 billion and imports of $1.93 billion. The country's cumulative trade balance for the first five months, however, stands in deficit by $1.81 billion. Although exports have risen at a 34% annual rate during the first five months of 1980, imports have soared at a 50% rate over the same period, paced by higher oil costs. The export performance has been surprisingly strong, given the slowdown in world economic growth, but greater restraint is clearly needed on the import side. Recognizing this need, the Government has just requested a new $1.1-billion reduction in public-sector imports and a $2.6-billion cut in spending by state companies. Such restrictions, coupled with the hoped-for slowdown in overall demand, should reduce future import needs. But Brazil will still be hard pressed to keep its 1980 trade deficit as low as the $2.7 billion of 1979.

Taiwanese export-led economic growth will weaken in 1980.

The Taiwanese economy expanded by a real 7.4% in 1979, accompanied by an inflation rate of 11.3%. The rapid growth has been sustained in the first half of 1980, with real GDP growth running at an estimated 7% annual rate. Exports continue to lead the rest of the economy, with earnings for the January-April period up 28% above the year-earlier level, and volume up 15%. This strong export performance, however, is unlikely to continue through yearend, with a recession unfolding in the United States, Taiwan's principal market. In the meantime, inflationary pressures are mounting. Substantial wage increases and higher import prices have boosted the inflation rate to about 15%, a serious concern for the financially conservative government. For 1980 as a whole, Taiwanese economic growth is expected to slow to approximately 5%, a result of more restrictive monetary control and the weakening of exports.

Singapore's economy responds well to new industrial strategy.

Singapore's new industrial strategy appears to have got off to a good start. GNP grew by a real 9% in 1979, the first year of the plan's implementation. Manufacturing, which critics of the plan thought would be hurt by the strategy's high-wage policy, posted a real gain of 14%. The inflationary impact of higher wages was largely offset by productivity gains and a strong Singapore dollar, and consumer price inflation was kept to 4%. Prospects for 1980 remain bright, despite the increasing economic weakness in the West. Manufacturing is expected to continue to provide the major stimulus. Stepped-up oil exploration has firmly boosted the shipbuilding and industrial machinery sectors; the petrochemical industry is attracting heavy investment; and the electronics industry is undergoing a technological upgrading in response to the high-wage policy. Over all, real economic growth of approximately 8% and inflation of about 6.5% are expected for 1980.

Saving Bounces Back—But How High?

Now that consumers have put away their credit cards, personal saving is showing signs of reviving. From late last summer, through the autumn and winter months, personal saving as a percentage of disposable income languished at rates far below the post-World War II average. Recent Government reports, however, show a hardy turnaround in the proportion of income that consumers choose to save.

The savings rate in May rose to 4.9%, considerably more robust than the 29-year low of 3.5% recorded in January. Historically, consumers have elected to put aside an even greater share of after-tax income—more in the neighborhood of 5½%-6%—which suggests that there is room for the rate to rise still further. But given present economic circumstances, it is not clear how much higher the savings rate will climb.

Consumers are clearly going through a period of retrenchment, spurred by the continued decline of real income and the Federal Reserve's drastic measures to curb the use of credit. An easing of inflationary expectations, coupled with a growing concern over the severity of the current economic downturn, has subdued consumers' frenzied buying to beat future price increases—for the moment at least. Consumer expenditures are down, particularly durable goods purchases. And the latest report on consumer credit showed that instalment credit outstanding plunged a record $1.99 billion in April, the first decrease in consumer credit since May of 1975. The upcoming statistics for May 1980 are expected to show another hefty decline.

Whether consumers will continue to increase their saving will depend largely on what they perceive to be happening to the economy. Historically, in periods of rising unemployment and increasing economic uncertainty, consumers have increased their rate of saving as a precautionary measure. The significance of this motive for saving has diminished over the years, however, as higher unemployment benefits have reduced the hardship of joblessness, and as government policymakers have demonstrated an increasing propensity to enact stimulative policies in times of economic decline.

Since the current political climate makes a tax cut a virtual certainty, consumers' expectations of this legislation may well revive their interest in spending. On the other hand, the tax "cut" may prove to be illusory. It is not likely that any reduction in tax rates on personal income will be sufficient to offset the increased consumer tax bite in 1980-81 from higher payroll taxes for Social Security and "bracket creep" caused by inflation.

In any event, there is considerable uncertainty over the direction of any consumer response to tax cut legislation. If consumers interpret a tax cut proposal as a sign that policymakers have abandoned the fight against inflation, they could start another round of panic buying that could torpedo savings again.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALAN			
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Africa	Algeria	Agreements reached with SOHIO and France's CFP on oil exploration programs.	Mar.	+ 95%	24.6	$ 1,374	Apr.	3,312	+ 53%	5.3
	Cameroon	Real economic growth running at 6% per annum; domestic market very buoyant.	June '79	+ 13%	4.0	500	Dec.	126	+140%	1.0
	Egypt	New budget provides for larger basic commodity subsidies and higher public-sector wages.	Dec.	+121%	16.4*	400	Jan.	760	+ 34%	2.5
	Ivory Coast	Budget for 1980 increases investment spending by a nominal 30%.	Nov.	+ 30%	7.6	1,440	Feb.	26	− 94%	0.1
	Liberia	Economic stagnation continues, with no improvement in sight.	Oct.	− 5%	0.9	525	Apr.	40	0	1.0
	Malawi	Development expenditure down sharply, owing to worsening fiscal situation.	Dec.	+ 25%	1.3*	225	Apr.	46	− 10%	1.5
	Morocco	Expansion of cement and sugar output under study; World Bank lends $34 million for agriculture.	Dec.	+ 19%	12.8	678	Mar.	334	− 23%	1.3
	Nigeria	Civilian government seeks to expand agri- and manufacturing industries.	Mar.	+ 93%	50.7*	625	Apr.	6,697	+235%	6.1
	Senegal	Forthcoming revision of investment code should enhance investment climate.	n.a.	—	2.3***	430	Feb.	15	− 47%	n.a.
	Sierra Leone	Economic deterioration continues; crash program instituted to stimulate rice production.	Dec.	+157%	0.7	210	Apr.	55	+ 36%	1.6
	South Africa	Private spending fuels GDP growth of an estimated 6% in 1980; investment boom not far off.	Mar.	+ 71%	57.3*	2,070	Apr.	679	− 5%	0.8
	Sudan	New projects will be aimed at eliminating infrastructural bottlenecks.	Oct.	+ 55%	9.1*	508	Apr.	54	+116%	0.5
	Tunisia	Industrial output rose 10.3% in 1977, led by energy and construction.	Dec.	+ 52%	5.9	966	Apr.	629	+ 70%	2.8
Middle East	Iran	New emergency budget based on oil revenue of $10 billion this year, vs. over $20 billion in 1979.	Mar.	+700%	76.4***	2,227	Jan.	14,702	+ 24%	23.0
	Iraq	Expenditures on infrastructural development rising sharply.	Mar.	+122%	23.3	1,875	n.a.	—	—	—
	Kuwait	Kuwait Oil Tanker Co. plans to expand its fleet from 15 ships to 27 by end-1982.	Mar.	+ 61%	13.9**	12,278	Apr.	2,564†	− 4%	6.8
	Saudi Arabia	Budget for 1980/81 sets $73.6 billion in expenditures, up 27% from actual spending last year.	Mar.	+ 95%	54.5**	8,400	Apr.	19,744†	+ 13%	9.5
	United Arab Emirates	Federal budget allots $514 million for investment projects.	Mar.	+ 87%	13.8	19,435	Apr.	1,430†	+ 60%	3.2

*1979 **FY 1977/78 ***1977 †Excluding state

Monetary Policy: To Ease or Not to Ease?

The meeting of the Federal Reserve's Open Market Committee (FOMC) this Wednesday is considered especially important by money market participants. At this meeting the FOMC will review its current growth targets for the monetary aggregates and lay the groundwork for Chairman Paul Volcker's semiannual congressional testimony July 22. Federal Reserve actions in the credit markets following the July 9 meeting will be examined closely for insights into the Fed's current strategy of monetary policy.

As usual, there is widespread disagreement over what will be decided at the upcoming FOMC meeting. Those who maintain that the Fed will lower its trading range for the Federal-funds rate base their argument on recent slow money growth and the weakness of the economy. At the time of the FOMC meeting, the two most widely watched monetary aggregates, M_{1a} and M_{1b}, will almost certainly be below their target growth rates set earlier this year—despite double-digit money growth in June. The most recent bank-loan and consumer-credit data are also likely to show extraordinarily weak growth. Furthermore, economic data released prior to the meeting should indicate a further slowing in economic activity. Some observers argue that because of these forces—and because the Fed must go before Congress and explain the coincidence of slow money growth and a severely depressed economy—the FOMC will decide that further credit-easing is warranted.

Others, however, contend that the Committee will not lower its Federal-funds rate target. They point out that money growth has begun to accelerate in June, and that the Committee is concerned that further acceleration in the near term may result from recent sharp declines in interest rates and from a large increase in Social Security payments in early July. This prospect, they believe, will lead the FOMC to hold off on any further rate declines. They also note that growth of the broader M_2 aggregate in June should be near its targeted level, and they believe that many members of the FOMC place significant weight on the behavior of this aggregate. They also argue that any further decline in U.S. short-term rates will cause the dollar to depreciate further on the foreign exchange markets, and that this potential will be weighed heavily at the July 9 meeting. Finally, they argue that further rate declines will be viewed by the FOMC as unwarranted in the light of recent inflation data.

To some extent these different opinions reflect the divergent views among the members of the FOMC itself. Many economists—including those within the Fed system—have noted that there are significant disagreements among FOMC members over the proper role of monetary policy, as well as over the relative weights that should be attached to various economic data in formulating monetary policy. Thus, Fedwatchers will be watching the Fed especially closely later this week for signs of any policy change.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes							
e of IMF eds, mil- s of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	central bank rate July 1, 1980	exchange rate in U.S. dollars July 1, 1980	current monetary conditions	
0	Negotiations on LNG export prices resumed with France.	June '79	+ 14%	Sept.	+ 28%	—	.2725	A $242.5-mn. export finance package signed with France.	**Algeria**
0	Trade deficit shows improvement, despite lower cocoa earnings.	Nov.	+ 8%	Dec.	+ 14%	—	.0049	Net foreign assets in surplus.	**Cameroon**
301	Suez Canal revenue rising sharply.	Dec.	+ 10%	Jan.	+ 20%	10.00%	1.45	Foreign banks must put 15% of fx deposits in central bank.	**Egypt**
0	Weak cocoa price and coffee crop preclude current-account improvement.	Feb.	+ 16%	Sept.	+ 28%	8.00%	.0049	External debt-service costs soar.	**Ivory Coast**
38	Trebling of ship tonnage tax should double 1980 revenue.	Nov.	+ 13%	Nov.	+ 39%	—	Par	Credit is restrictive.	**Liberia**
7	Stepped-up industrialization will require growing imports in 1981.	Feb.	+ 17%	Mar.	+ 29%	10.00%	1.26	Credit restraint aimed at curbing imports.	**Malawi**
193	Austerity program slows growth of imports.	Feb.	+ 8%	Feb.	+ 12%	4.50%	.2600	Money supply expanding more slowly.	**Morocco**
0	General import restraint continues, despite selective relaxation.	July '79	+ 10%	July '79	+ 14%	5.00%	1.915	Interest rates will be raised to to spur savings.	**Nigeria**
55	Higher food imports and poor export earnings portend payments weakness.	Dec.	+ 9%	Sept.	+ 35%	8.00%	.0049	Credit growth being restricted.	**Senegal**
35	Bunching of 1980-82 debt repayments eased by $120-mn. rescheduling.	Dec.	+ 21%	Feb.	+ 31%	—	.9925	Credit to public sector expands strongly.	**Sierra Leone**
62	Trade surplus narrows in April-May, as exports contract and imports rise.	Mar.	+ 13%	Feb.	+ 12%	7.00%	1.3010	Credit demand rises sharply.	**South Africa**
250	Lower cotton earnings and poor prospects for other exports this year.	Mar. '79	+ 27%	Feb.	+ 26%	—	2.0225	Need for balance-of-payments support continues.	**Sudan**
31	Oil output holding steady at 100,000 barrels per day.	Jan.	+ 11%	Feb.	+ 10%	5.75%	2.55	World Bank lends $37 million for TransMed pipeline link.	**Tunisia**
0	Oil exports down; official price held unchanged since April 1.	Feb.	+ 15%	Sept.	+ 12%	9.00%	n.a.	Emergency budget points to faster rise in bank credit.	**Iran**
0	Oil revenue supports continued increase in imports.	Sept.	+ 12%	n.a	—	—	3.41	Credit generally available.	**Iraq**
0	Oil export price raised $2 per barrel.	Dec.	+ 5%	Feb.	+ 35%	—	3.75	Drop in Eurodollar rates reduces outflow of private funds.	**Kuwait**
0	Oil output and prices held constant, but future strategy uncertain.	Dec.	+ 2%	Jan.	+ 87%	—	.3015	Credit to private sector increasing rapidly.	**Saudi Arabia**
0	Abu Dhabi holds oil export price constant.	n.a.	—	Feb.	+ 8%	—	.2713	Bank loans to private sector increasing.	**United Arab Emirates**

erves

World Interest Rates

market rates of July 2, 1980; bond yields as of June 30, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	10.63	17.00	13.00	9.50	7.50	15.00 penalty rate 18.00	9.50*	3.00	9.00
Day-to-Day Money	9.25 July 2	13.00	17.25	13.00	12.50	10.50	16.875	10.50*	3.50	12.6875
Treasury Bills 91-day, Middle Rates	8.09	10.50	15.625	13.75	12.40 one-year	n. a.	14.45 90-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	7.625 finance paper	11.50 finance paper 15% tax w/h	14.71	12.90 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.65	11.40 15% tax w/h	16.125	12.90 Certified	not traded	9.90	18.50	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.00	11.80	13.38	10.76 20% tax w/h	12.96	8.01	15.34	9.87*	4.72	8.22
Industrial Bonds prime, long-term, new and old issues, average yield	11.10 Aa Industrials	12.20	13.98	14.09	13.88	8.01	15.32	10.73*	5.61	7.40
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.25	18.00	18.25	14.60	11.50	20.00	12.50*	5.50	9.25
Bank Time Deposits 3-month	8.00 Cert. of Dep.	11.40 Cert. of Dep.	16.8125	13.70	12.50	9.85	10.75	10.50* large deposits	5.625 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.6875	no market	17.0625	no market	12.625	9.5625	no market	10.5625	5.75	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8691	2.3585	.035508	.2448	.5677	.001187	.5190	.6156	.004562
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.85 *D*	7.05 *D*	3.80 *D*	2.75 *D*	.28 *P*	18.50 *D*	.85 *D*	4.10 *P*	2.45 *D*

Eurodollar Deposits
(London interbank, bid)
July 2

7-day	9.3125
1-month	9.3125
3-month	9.375
6-month	9.5625

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .27
U.S.-Canada Treasury Bills	− .19
U.S.-Canada Finance Co. Paper	−1.87
Eurodollars-U.K. Local Auth. Deposits	− .39

Eurobonds
(average yield on recent straight debt issues)

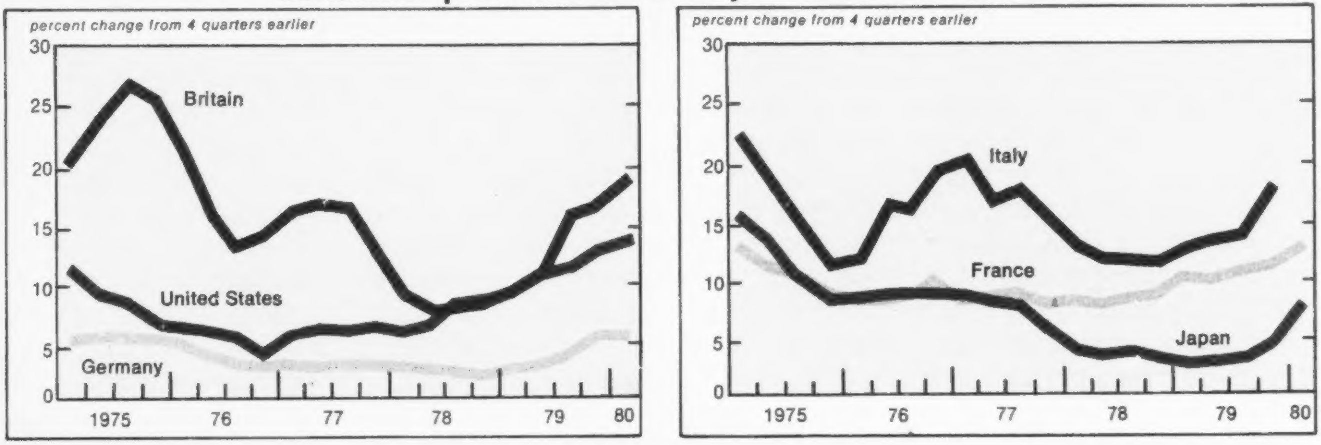
U.S. Dollar Bonds	
7 yrs. and under	10.75
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	8.00

Gold Price
London
afternoon fixing

661.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of June 25; bond yields as of June 20.

Consumer price trends in major industrial countries



Austria Maintains Anti-Inflationary Policy

Austria's economy is small and open, but well-developed and diversified. While agriculture has declined in relative economic importance at the expense of the services sector, a common evolutionary feature of developed economies, the external sector continues to dominate economic activity. Exports and imports together account for about 50% of GDP.

The unusual economic trend on the Austrian scene is the declining importance of manufacturing. The share of mining and manufacturing in total GDP fell from 34.5% in 1970 to 29.8% in 1978. This is the direct result of an exchange-rate policy that reflects the authorities' willingness to accept the deflationary consequences of a strong currency in the interest of minimizing inflation.

Austria's "hard-schilling" policy was instituted in 1973 with the tying of the nation's currency to the German mark, a logical choice since Germany is Austria's most important trading partner. The linkage boosted the trade-weighted value of the schilling and initially dampened Austrian export price competitiveness. But the strong currency also cut import prices, and since much of Austria's industrial output is tradable and in direct competition with imports, Austrian firms were constrained in raising domestic prices. While this did hold down inflation, it also squeezed industrial profits and encouraged a shift in production out of traded goods and into services.

The firm-exchange-rate policy eventually reduced the rate of labor cost increase, so that between 1977 and 1979, industrial unit labor costs in schilling terms showed virtually no increase. This allowed Austrian international competitiveness to remain nearly unchanged through mid-1979, after which it worsened again as the schilling was revalued in response to a DM revaluation.

The economy in 1979

The Austrian economy turned in one of the strongest European growth performances last year. Real GDP rose 5.2%, one of the highest rates in the OECD. Real consumption increased 5.1%, investment rose a real 9.3%, and export volume climbed nearly 11%.

This growth was essentially confined to the private sector, as fiscal policy was not expansive last year. Government spending as a percent of GDP even declined slightly, from 25.8% in 1978 to 25.7%, and the net budget deficit fell to 3.5% of GDP from 4.2% in 1978. Nonetheless, the Government's debt-service burden continued to increase rapidly. Debt service as a proportion of total Federal spending jumped from 9.6% in 1977 to 11.7% last year.

Monetary policy was similarly restrictive in 1979, largely aimed at maintaining the schilling's parity with the mark. Austrian interest rates have thus tended to follow those in Germany, adjusted for such other factors as the current-account balance. Consequently, rising German interest rates and a widening current-account deficit forced an increase in Austrian interest rates in late 1979 and early 1980.

The authorities were reasonably successful in fighting inflation last year. Consumer prices rose by only 3.7%, compared with 3.6% in 1978, as industrial unit labor costs dropped 0.5%.

The only Austrian economic indicator that performed poorly last year was the balance of payments. The trade deficit widened from $3.6 billion in 1978 to $4.5 billion. And despite an improvement in Austria's traditionally positive invisibles balance, the current-account gap widened from $1.4 billion in 1978 to $1.9 billion.

Fiscal policy has continued to be restrictive in 1980. As a result, the net Federal government borrowing requirement is expected to fall to 3.1% of GDP. (A recession in the latter part of the year, however, may well raise this figure.) Monetary policy will also continue restrictive, and interest rates may have to be boosted further before they begin descending late in the year, in a lagged response to falling German rates. The inflation rate, however, is expected to rise to about 6%. And with the savings ratio unlikely to drop, the consequent erosion in the real value of nominal earnings will keep real consumption growth to no more than 2.25%. Investment spending growth is also forecast to slow, to about 3.5%. On balance, Austria will post real economic growth of about 2% in 1980.

On the external front, substantial deterioration in the balance of payments is expected this year. The German economic slowdown will hold Austrian export volume growth to some 5%, while higher oil costs will strongly boost import expenditures. With petroleum prices expected to average 60% more than in 1979, Austria's oil import bill will swell by about $1 billion to approximately $2.8 billion. This sharp increase will help widen the current-account deficit to an estimated $3 billion.

The economy is likely to continue weak through 1981. Real GDP growth is provisionally estimated to drop to 1.5% next year, a result of restrictive policies and continued high payments deficits stemming mainly from higher oil bills. Indeed, with the resource cost of further energy conservation greater in the 1980s than in the last decade, Austrian growth—along with growth throughout the industrialized West—is likely to remain relatively depressed for the next five years or so.

George de Nemeskeri-Kiss
Chase London

The Euromarket and the OPEC Surplus

When the Organization of Petroleum Exporting Countries set off the first round of oil price hikes in 1974, many observers sounded the danger alarms for the international banking system. Bankers wondered how $65-billion worth of OPEC surplus funds could possibly be channeled to the countries that required them without the entire system breaking down. The Eurocurrency market, however, met with no problem in recycling the surplus. Indeed, the Euromarket has demonstrated that it is perhaps the most efficient and resilient money market the world has known.

The international economy is now adjusting to another major oil price shock. Predictably, the alarms are being sounded again, albeit somewhat more reservedly. Equally predictably, the Eurocurrency market appears to be functioning as efficiently as ever. Circumstances are somewhat different this time around, however.

First, when oil prices exploded in 1974, the Eurocurrency market was less experienced in making large loans to national borrowers. Consequently, the cost of these loans—the spread over LIBOR—was often quite high, and the time necessary to complete a large financing was often interminable. However, deficit countries did succeed in obtaining the financing they required. Between 1974 and 1979, the Eurocurrency market gained much experience in lending and in risk assessment. During that same time, the actual risks of international lending declined, partly because of the relative calm on the oil market. The spreads on Euromarket syndicated loans therefore fell dramatically. With the onset of the latest round of oil price increases, these spreads will undoubtedly rise, but only a small number of countries will be charged the same high spreads that prevailed in 1974.

Second, some national borrowers have begun to diversify into bond markets during the last half-decade. In 1974, the less-developed countries (LDCs), including the oil exporters, obtained only about 9% of their external financing through international bonds. By 1977, these same countries were satisfying about 19% of their needs through bonds. Thus, while external financing pressures on the Eurocurrency market will arise during the current recycling, the international bond market will be playing a small but continually growing role.

These developments should minimize the difficulty of the current recycling challenge. But some new serious problems do exist. Perhaps most important is the impact that this OPEC round will have on the economic growth rates of the developing countries. For the most part, the LDCs were spared most of the real growth consequences of the first round of oil price hikes. This is because they were relatively underborrowed in 1974 and had the flexibility to increase their debts to pay their oil bills without having to curtail investment projects. Currently, the LDCs are much nearer their "appropriate" debt/growth ratios, and are, in many cases, up against their borrowing limits with the major Western banks. Consequently, there are likely to be some real growth effects this time around. The era of very rapid annual economic growth for some LDCs may evolve into a decade of still rapid but much more restrained growth.

The realization that slower growth for certain LDCs is virtually inevitable is what most concerns world leaders in the current round of recycling. To be sure, the Euromarket will assist in recycling the OPEC surplus once again. And the multilateral lending institutions, such as the World Bank and the IMF, may be able to support countries with the most severe adjustment problems. But this time, the non-oil developing world will probably have to pay the painful price of forgone economic growth.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	**IIQ/79**	**IIIQ/79**	**IVQ/79**	**IQ/80**	**1978**	**1979**	**1980**
Gross Size (Claims)	946.6	1,041.5	1,110.9	1,100.0	892.7	1,110.9	1,350.0
Net Size (Claims)	585.0	635.0	665.0	670.0	535.0	665.0	825.0
Liabilities to Private Nonbanks	155.0	165.0	170.0	172.0	140.0	170.0	210.0
Claims on Private Nonbanks	295.0	310.0	320.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	243.8	260.8	273.4	270.0	222.7	273.4	330.0
Liabilities to Private Nonbank Foreigners	57.6	61.9	62.3	64.0	54.8	62.3	72.0
Total Claims on Foreigners	306.1	330.7	338.6	335.0	293.0	338.6	420.0
Claims on Foreign Public Borrowers	36.1	39.6	41.3	42.0	33.9	41.3	55.0
Claims on Foreign Private Nonbank Borrowers	107.6	113.1	118.6	120.0	104.2	118.6	140.0

Note: *Gross* and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

CHASE

International Finance

Vol. XV, No. 15
July 21, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

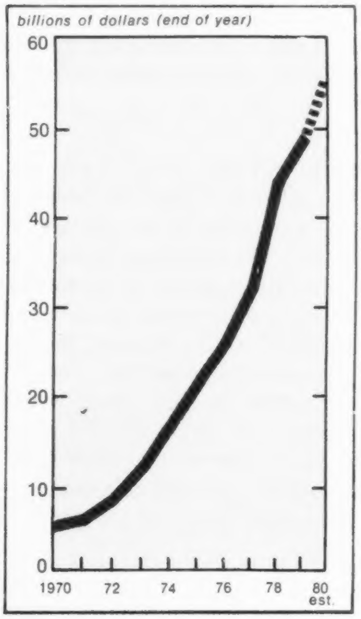
7/23/80 B 1900-1 U

Brazil's Difficult Dilemma

Brazil is currently in the midst of its most critical socioeconomic period in the last decade. The inflation rate is approaching 100%; the oil import bill accounts for more than half of total import costs; the current-account deficit is widening; external debt exceeds $50 billion; and industrial employment growth is declining. These economic difficulties coincide with a political liberalization process now under way and with the revival of labor unionism that has produced wage grants equal to or greater than the rate of inflation.

The authorities have responded to these economic pressures with restrictive monetary, credit, tax, and spending policies aimed at suppressing demand growth. The most recent drastic measure adopted was a $2.6-billion cut in the expenditures (including imports) of state enterprises. The agricultural sector, however, is exempted from the policy austerity as Brazil is seeking to supplement agricultural supplies with expanded farm production. With a downturn in aggregate demand and increased farm output, there should eventually be a reduction in inflation and improvement in the trade balance. The standard forecast for 1980 is for real GDP growth of 5%, compared with 6.4% last year, and an inflation rate running at about 80% by yearend. A 5% real growth rate—good by current world standards—would conform to the authorities' goal of stabilizing the economy.

Growth of Brazilian public and private external debt



Brazil's internal problems are compounded by a troubled world economic situation. A world economy experiencing slower growth presents problems for Brazil, whose economic development strategy consists of export-led manufacturing growth and heavy reliance on foreign capital inflows. Brazil's total external funding needs, which include financing for its current-account deficit and debt amortization, could reach almost $20 billion this year. But with an international financial community increasingly concerned about recycling and country risk exposure, the Brazilian Government must demonstrate that the measures now being implemented will ultimately improve the country's economic situation. Thus far, economic indicators are suggestive of some progress toward stabilization and balance-of-payments improvement, but more time is needed for confirmation of a turnaround in the Brazilian performance.

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Easing monetary growth in U.K. spurs early interest rate decline.

Recent statistics suggest that the United Kingdom's rate of inflation has peaked. Retail prices, rising at an annual rate of nearly 22%, are expected to begin easing between now and yearend, while wholesale price increases, which peaked at 19% in March and April, are now running at 17.6%, with further improvement expected. The falling rate of inflation and the gathering recession are beginning to moderate the demand for money, and monetary growth is now falling toward the Government's target of 11%. In the face of great pressure to lower the record interest rates, the authorities reduced the Bank of England's minimum lending rate (MLR) from 17% to 16% on July 3. The rate reduction is a rather anticipatory, if not risky, action, as the money supply is not yet on target, and the removal of the corset constraints on the banks may well trigger a surge in the broad money supply (M_3) during July and August. The cut in rates, however, may help moderate wage demands as Britain enters its tough annual wage bargaining round. Moreover, the market expects interest rates to be still lower by yearend, even if a further rate move is not imminent. This expectation has been reinforced by sterling's response to the drop in rates. Just prior to the MLR reduction, sterling stood at $2.36 and DM 4.16; four days later it was worth $2.38 and DM 4.14.

Italy's mounting deficit and high inflation bring forth deflationary measures.

Faster-than-average economic growth and higher oil bills have led to a rapid deterioration in the Italian external accounts. A trade deficit of 1.5 trillion lira in May brought the total deficit for the first five months of 1980 to 6.8 trillion lira ($8.2 billion), compared with a gap of lit. 1.4 trillion ($1.6 billion) for the year-earlier period. With inflation continuing at a year-over-year rate of more than 20%, downward pressure on the lira has mounted. The authorities responded by announcing a package of measures designed to reduce public-sector borrowing by some 2.8 trillion lira in 1980. Value-added tax rates will be consolidated and raised somewhat, taxes on gasoline will be boosted, the campaign against tax evasion will be intensified, and a 0.5% levy on worker salaries will be used to assist companies in financial distress. The system of wage indexation, however, will remain unchanged. The new measures should have a mildly deflationary impact in the second half of the year, but much depends on the success of the effort to reduce tax evasion. Nonetheless, strong real economic growth in the first half should still give Italy an average real growth rate of almost 4% for 1980.

Despite high inflation, Iceland's economy sustains satisfactory GDP growth.

The Icelandic economy is performing favorably, but with minimal government control over monetary conditions and the rate of inflation. Despite a slowdown in the economies of its trading partners, the country is expected to post real economic growth of 2% this year, compared with 2.4% in 1979. The ineffectiveness of official monetary control was underscored recently by the Government's postponement of increases in interest rates scheduled for March under the Economic Policy Act. The country's inflation rate averaged 45% in 1979, reached 60% by yearend, and is unlikely to drop below 50% anytime in 1980. In his annual address, the governor of Iceland's central bank sharply criticized the authorities for their unwillingness to deal with excessive monetary growth and emphasized the threat that the resultant high inflation poses to the economy. He reiterated, however, that with Iceland's huge resources of cheap hydro- and geothermal energy, and with full control of its fishing grounds, there was no reason it could not sustain economic prosperity.

Puerto Rican economy slows, but full effects of U.S. recession yet to come.

The Puerto Rican economy is feeling the pinch of the U.S. recession, although the impact is not yet severe. Indications of an economic slowdown include declines in manufacturing employment growth, a drop in private housing construction, and a fall-off in the growth of exports and tourist arrivals. Offsetting some of this slowness, however, have been the Commonwealth Government's contra-cyclical spending and investment and some reductions in personal tax rates. It is estimated that during the fiscal year ended June 1980 real GDP grew less than 1%, compared with 5.5% in the previous fiscal year. There is concern that the brunt of the U.S. recession has still to hit Puerto Rico and that the island could experience a sharper downturn in the remaining months of the year. Consequently, the unemployment rate, which has stood virtually unchanged at slightly over 16% from May 1979 through May 1980, could rise if the economy weakens further.

Guatemala hindered in 1979 by balance-of-payments weakness and political problems.

Guatemala's rate of real economic expansion slowed to 4.5% in 1979 from an annual average of more than 6% in the previous two years. This deceleration was attributable primarily to a weakening balance of payments and internal political disturbances. Higher import prices have boosted the country's inflation rate from 8% in 1978 to 11% in 1979, a rate that has since been maintained. On the external front, a deterioration in the world prices of Guatemala's principal exports, a higher oil import bill, and a decline in manufactured exports helped widen the current-account deficit from $35 million in 1977 to $260 million in 1979. These deficits have been financed mainly through private capital inflows and public-sector borrowing. The country's international reserve position remains strong—partly the result of foreign-exchange controls introduced in mid-April—and as of end-May, official reserves totaled $650 million, sufficient to cover about five months of imports.

Korean economic growth to contract sharply this year.

The Korean economy is in the midst of a difficult adjustment. Exports, hit both by the U.S. recession and foreign purchasers wary of the political situation, have declined in volume terms, slowing the overall rate of economic growth significantly. Real GDP, which grew 7.1% in 1979, is officially forecast to increase by only 2% this year. Meanwhile, the rate of inflation is racing ahead at an estimated 40% pace, and the current-account deficit is widening. The Government recently announced an estimated foreign capital requirement of $16 billion for 1980 and 1981. Recent economic reforms aimed at revitalizing the financial and manufacturing sectors and investments in industrial restructuring now being made will take another year or two to show results. There is, however, little doubt about Korea's ability to return to a strong growth path in the medium term, building on its existing infrastructure and modern industrial capacity and aided by the anticipated upturn in worldwide economic activity.

Hong Kong's rapid economic growth pace will slow only slightly in 1980.

Spurred by 40% growth in export earnings, Hong Kong's GDP advanced by 11.5% in real terms in 1979, with an inflation rate of 11.6%. And the brisk pace of economic activity continued into the first half of 1980. The value of exports was up 30%-35%, and real GDP grew at nearly a 10% annual rate. Although fuel price increases boosted the year-over-year inflation rate to approximately 15%, further deterioration was limited by a stable exchange rate. It appears unlikely that the high growth rate can be sustained for the remainder of the year. Export orders are weakening, with a number of cancellations reported, as a result of the U.S. recession. On balance, a slowdown in real economic growth to about 8% for the year is expected. This, combined with an anticipated lull in the world oil market, should help decelerate the rate of inflation to about 13%.

Gabon aims to lessen dependence on oil earnings.

Higher oil export revenues and stabilization policies begun in 1978 succeeded in returning Gabon's balance of payments to equilibrium in both 1978 and 1979; eliminating payments arrears (via repayment and rescheduling); and bringing the rate of inflation down to single digits last year. However, in view of the country's limited oil reserves, which are likely to be depleted during this decade, and the uncertainty surrounding the commercial viability of recent oil finds, the Government has embarked on a medium-term policy of balanced growth. The policy is aimed at diversifying the economy to lessen its dependence on oil earnings. The major priority is completion of the Transgabon Railroad to permit exploitation of the substantial natural resources in the interior (e.g., timber and minerals) and the country's vast agricultural potential. The capital intensity of the railroad project implies strong import growth during the early 1980s, and could, coupled with the continued slowdown in the growth of oil output, result in renewed balance-of-payments deficits and inflationary pressures in the medium term.

A Brief Respite for Unemployment

The nation's jobless rate dipped very slightly in June, a welcome relief from unemployment's giant-sized jumps in April and May, but one likely to be all too brief. For despite the June showing, the Labor Department's alternative measures of the employment situation indicate that the current job market is anything but stable. And other government reports suggest that the unemployment rate at mid-year was only stopping to catch its breath before continuing on an upward path.

The vast array of statistics accompanying the unemployment figure confirmed the increasingly widespread weakening of the job market. For example, total employment declined for the fourth month in a row. Since its peak in February, the total number of persons employed has fallen by about 1.4 million, with adult men experiencing the bulk of the increased job losses. The employment-population ratio in June dropped four-tenths of a point to 58.1, its lowest level in over two years. And the proportion of unemployment resulting from layoffs and job terminations continued to rise, while fewer persons voluntarily quit their jobs or were unemployed because they were just entering or reentering the labor force.

Manufacturing continued to be the sector hardest hit by job losses, particularly durable-goods industries. The Labor Department reported that the weekly average number of hours worked in manufacturing declined for the fifth consecutive month. And the Federal Reserve announced that its industrial output figures for June showed continued large cutbacks in manufacturing production. June also marked the first month in which there were clear signs that unemployment was spreading to the services sector of the economy. All of this suggests that it is highly unlikely that unemployment has peaked. Most economists are predicting that the recession has some distance to go before bottoming out, and that the unemployment rate may rise as high as 9%.

The June hiatus in the unemployment rate's ascent may not have been representative of what was happening in the labor market. But it did perhaps provide at least some temporary easing of pressures to adopt a hastily constructed program to stimulate the economy. Rapidly rising unemployment rates in the past have consistently triggered a shift in public concern from anxiety over the costs of inflation to anxiety over the costs of unemployment. And even though economists are predicting that the current recession, while steep, will also be relatively short, it will be difficult for government policymakers to ignore those concerns in an election year—regardless of the long-run consequences for the fight against inflation.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE			
		3 months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered
Austria	Economy set to slow; year-over-year inflation rate reaches 6.4%.	Dec.	+ 7.6%	68.9	+ 5.3%	May	3,613	+ 5.0%	2.2
Belgium	Economic slowdown expected; public-sector deficit to top 10% of GNP this year.	Dec.	+ 1.0%	111.5	+ 3.0%	May	6,449	+ 20.0%	1.1
Britain	Recession deepening; steep drop in industrial output and retail sales; unemployment at 6.3%.	Mar.	+ 1.4%	391.2	+ 0.5%	Apr.	21,826	+ 26.7%	2.4
Denmark	Chronic balance-of-payments problems force recessionary policies; GDP decline expected.	Feb.	+ 9.2%	65.6	+ 2.5%	May	2,244	− 51.3%	1.4
Finland	Economic growth slowing, but pace will remain one of Europe's fastest.	Dec.	+ 7.6%	41.6	+ 7.2%	May	1,822	+ 11.5%	1.7
France	First-quarter GDP grew at same rate as IVQ 1979, but recessionary forces are building.	Mar.	+ 3.2%	566.9	+ 3.0%	May	25,656	+ 67.7%	2.7
Germany	Economy shows signs of downturn as both production and orders drop.	Mar.	+ 6.9%	755.8	+ 4.2%	May	48,072	+ 6.2%	3.4
Greece	Economy slows further as Government announces additional anti-inflation measures.	Dec.	+ 1.7%	37.5	+ 3.5%	Apr.	871.1	− 11.5%	1.0
Ireland	Deflationary budget will reduce GDP growth to about 1% this year.	Dec.	+ 5.0%	14.9	+ 3.3%	May	2,092	+ 5.6%	2.3
Italy	Fiscal policy tightened; 4% real economic growth rate estimated for 1980.	Mar.	+10.3%	318.6	+ 5.0%	May	22,255	+ 22.2%	3.4
Netherlands	Incomes policy extended for remainder of 1980; domestic demand expected to be flat.	Feb.	+ 1.5%	151.8	+ 3.2%	May	10,205	+ 34.6%	1.7
Norway	Economy remains buoyant, but non-oil sector suffering from accelerating inflation.	Mar.	+ 3.0%	45.3	+ 2.7%	May	4,916	+ 24.2%	3.9
Portugal	Renewed labor disputes could inhibit economic recovery.	Oct.	+ 9.0%	20.2	+ 3.0%	Apr.	575	− 3.0%	1.1
Spain	Domestic economy remains depressed.	June '79	0	197.4	+ 1.5%	Apr.	11,613	+ 4.8%	6.1
Sweden	Weakness in trade leads to slowdown in domestic economy.	Mar.	+ 5.8%	103.3	+ 4.1%	May	3,307	− 17.1%	1.4
Switzerland	Business outlook continues promising.	Dec.	+ 4.4%	94.1	+ 0.7%	May	11,996	− 16.0%	4.9
Canada	Drop in auto production reduces total manufacturing output; some industries show small gains.	Mar.	− 1.3%	222.8	+ 2.8%	May	3,236	+ 4.5%	0.5
United States	Prospects for reduced inflation as recession's effects spread.	June	− 2.3%	2,349.0	+ 2.0%	May	10,620	− 2.4%	0.5

Whither Monetarism?

The recently released minutes of the May 20 meeting of the Federal Open Market Committee (FOMC) reveal sharp differences among members about policy, as well as some ambivalence in the articulation of operating strategy. The proceedings tend to raise questions about the degree of FOMC commitment to the attainment of money growth targets. And they have also generated some concern that a greater orientation to interest rate targets could lead eventually to excessive money growth.

To review briefly, last October the FOMC announced its intention to place greater emphasis in day-to-day operations on the supply of bank reserves and less on confining short-term fluctuations in the Federal funds rate. The objective, of course, was (and presumably remains) the enhancement of the FOMC's performance in achieving targeted money growth. Neither in October nor subsequently, however, has the FOMC indicated what it believed a suitable bank-reserve target to be. Consequently, some doubt has persisted about how much FOMC operating tactics have really changed.

Turning to the May 20 FOMC minutes (the latest available, since there was no June meeting), several elements are of particular interest in assessing the likely course of monetary policy over the balance of 1980. First, the economy was then weakening rapidly, and a substantial shortfall of money growth was in progress (e.g., M_{1B} was back to about the same level as at yearend 1979). Second, while it was agreed the money shortfall should be reversed, there was no consensus about the period of time over which a return to the 4%-6½% longer-run growth track should be sought. Third, there was marked aversion to a further pronounced fall in the Federal funds rate (which had already dropped from a peak of almost 20% to the 10% range). And finally—probably most important of all—there was concern that ". . . aggressive efforts to promote monetary growth might have be be reversed before long, perhaps leading to significant increases in interest rates in a period of substantial weakness in the economy." This caveat, of course, substantially constrains any concerted efforts to achieve money growth targets.

Against this background, the FOMC's operating directive was couched in terms of an 8½%-14% range for the Federal funds rate. This range was expected to be consistent with May-June money growth somewhat above the longer-term objectives—an expectation largely fulfilled during June. But for the balance of 1980, recent Federal Reserve behavior, including the views expressed in the May minutes, has created new uncertainty over how the Federal Reserve will react to developments in the economy as a whole and in the performance of monetary variables in particular. Only a more consistent operating performance on the part of the Federal Reserve can allay market concerns that there has been some shift toward the pre-October policy orientation.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
MF mil- ollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	July 16, 1980		current monetary conditions	
	Jan.-Apr. current-account gap was 15.6 bn. schillings, double year-ago.	Apr.	+ 6.0%	Feb.	+16.6%	6.75%	.0812	Credit conditions remain restrictive.	**Austria**
	Current-account gap could hit $7 billion in 1980, vs. $3.8 bn. in 1979.	May	+ 6.5%	Dec.	+14.5%	13.00%	.0358	Interest rates ease as pressure on franc subsides.	**Belgium**
	Import growth slowing; current-account surplus of £32 million in May.	May	+21.9%	Dec.	+ 8.3%	16.00%	2.3715	Money policy remains tight, but MLR cut from 17% to 16%.	**Britain**
	High domestic demand continues to widen payments deficit.	Apr.	+14.3%	Feb.	+16.6%	13.00%	.1853	Monetary policy remains restrictive.	**Denmark**
	May trade surplus reduced cumulative 1980 deficit to 960 million markkaa.	Apr.	+10.7%	Dec.	+18.8%	9.25%	.2774	Interest rates remain high.	**Finland**
	May trade deficit reached record FF 7.23 bn., presaging large 1980 gap.	May	+13.7%	Jan.	+17.5%	9.50%	.2468	FX controls relaxed slightly, but money policy stays tight.	**France**
	Foreign orders stronger than domestic, but trade terms worsen.	June	+ 6.0%	Feb.	+12.0%	7.50%	.5736	Interest rates at peak; autumn declines expected.	**Germany**
	Interest payments on expatriate deposits freed.	Apr.	+24.9%	Dec.	+18.3%	19.00%	.0235	Credit remains restrictive.	**Greece**
	High oil costs offset lower imports; payments balance unchanged from '79.	Feb.	+15.5%	Feb.	+24.9%	16.85%	2.1480	Interest rates declining from record-high levels.	**Ireland**
	Trade deficit increases dramatically.	June	+20.7%	Oct.	+17.9%	15.00%	.001203	Interest rates rise further.	**Italy**
	Gas prices readjusted to improve trade balance.	May	+ 6.6%	Feb.	+17.1%	9.50%	.5234	Interest rates ease as guilder strengthens in EMS.	**Netherlands**
	Current account will post a surplus this year, thanks to oil.	May	+ 9.4%	Feb.	+13.4%	9.00%	.2077	Pressure mounts for relaxation of tight money policies.	**Norway**
	Favorable tourism performance expected.	Apr.	+19.5%	Feb.	+24.0%	18.00%	.0215	Escudo crawling-peg devaluation cut to 0.5% per month.	**Portugal**
	Poor tourist season anticipated.	Mar.	+16.4%	Mar.	+18.7%	8.00%	.0141	Peseta remains weak.	**Spain**
	Very large current-account gap possible in 1980, owing to high wage awards.	May	+13.2%	Jan.	+18.6%	10.00%	.2425	Huge public-sector deficit forces tight money policy.	**Sweden**
	May trade gap double year-ago; current-account gap in 1990 very likely.	June	+ 3.3%	Mar.	+16.5%	3.00%	.6227	Steps taken to increase franc's reserve role.	**Switzerland**
	Trade surplus posted in May as imports declined.	May	+ 9.4%	Jan.	+21.2%	10.44%	.8671	Interest rates decline slightly.	**Canada**
	Strong services account should lead to current-account surplus in IIQ 1980.	May	+14.4%	May	+ 8.0%	11.00%	—	Bond prices highly volatile.	**United States**

World Interest Rates

market rates of July 16, 1980; bond yields as of July 11, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	10.44	16.00	13.00	9.50	7.50	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	8.625 July 17	11.00	16.50	13.00	12.25	10.00*	16.875	10.625	2.75*	12.875
Treasury Bills 91-day, Middle Rates	7.72	10.20	14.50	13.25	n. a.	n. a.	14.25 75-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.375 finance paper	11.00 finance paper 15% tax w/h	13.79	12.90 Certified	12.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.25	11.00 15% tax w/h	15.00	12.90 Certified	not traded	9.90*	19.30	no market	4.50* not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.32	11.75	12.86	9.80 20% tax w/h	12.87	n. a.	15.37	9.73	4.68*	8.352
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	12.50	13.82	13.74	13.85	n. a.	15.65	10.54	5.60*	7.31
Bank Short-Term Rate to Best Borrowers (prime rate)	11.25	13.00	17.00	17.50	14.60	11.50*	20.00	12.50	5.50*	9.25
Bank Time Deposits 3-month	8.25 Cert. of Dep	11.00 Cert. of Dep	15.5625	13.25	12.125	9.70*	10.75	10.3125 large deposits	5.125* residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.375	no market	16.00	no market	12.125	9.25	no market	10.3125	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8671	2.3715	.035804	.2468	.5736	.001203	.5234	.6227	.004570
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.71 *D*	6.24 *D*	3.83 *D*	2.75 *D*	.139 *P*	11.97 *D*	.841 *D*	4.11 *P*	3.24 *D*

Eurodollar Deposits

(London, interbank, bid)
July 17

7-day	8.875
1-month	9.00
3-month	9.125
6-month	9.9375

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−.34
U.S.-Canada Treasury Bills	−.38
U.S.-Canada Finance Co. Paper	−.76
Eurodollars-U.K. Local Auth. Deposits	−.135

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	7.875

Gold Price

London afternoon fixing

624.75

(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of July 9; bond yields as of July 4.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.4 (May)	9.4 (May)	21.9 (May)	13.7 (May)	6.0 (June)	20.7 (June)	3.3 (June)	8.2 (May)
Industrial production*	−7.5 (June)	0.8 (Apr.)	−6.5 (May)	0 (May)	0.8 (May)	7.9 (May)	9.0 (Mar.)	9.3 (May)
Trade balance† *(billions of local currency units)*	−$3.96 (May)	C$.578 (May)	−£0.02 (June)	−FF1.90 (June)	DM0.29 (May)	−Lit.1,510 (May)	−SF0.67 (May)	−¥1,521 (May)
Money supply (M_1)*	3.3 (June)	3.9 (May)	2.5 (Apr.)	11.5 (May)	1.5 (May)	22.4 (Nov.)	−13.0 (Apr.)	4.1 (May)
Velocity of money (M_1)*	2.7 (Mar.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	−0.2 (Sept.)	n. a.	3.8 (Dec.)
Reserves minus gold *($ million, change from previous month)*	273 (May)	247 (May)	294 (May)	257 (May)	−110 (May)	−542 (May)	842 (May)	542 (May)

* Percent change from 12 months earlier

† Figures are only for the month indicated

Efficient Markets and the Price of Gold

The gold market has regained some of its luster in the last two months, amid reports that gold flows reaching the market in 1980 will fall far short of the 1979 supply. Press dispatches suggest that South Africa may be withholding a portion of its newly mined gold from the market, and wide publicity has surrounded the release of a major report that details the sharp decline in gold supplies to the Western industrialized economies. That study, the authoritative *Gold 1980* issued by Consolidated Gold Fields Ltd. (CGF) of Britain, predicts a continuing long-run pattern of "rising but volatile gold price movements." For gold supplies in 1980, CGF projects falling output from mines in non-Communist countries and reduced gold sales by the Soviet Union, Western governments, and the International Monetary Fund.

On the demand side, the gold market apparently has been bolstered in recent weeks by investors shifting their funds out of U.S. securities as interest rates have fallen. Also important have been stepped-up purchases by third-world central banks, as well as the usual flows of capital scurrying for a safe haven in the face of political and economic uncertainties. The price of an ounce of gold, which plummeted below $500 at the end of March after peaking at $850 in January, rebounded last month and has remained above $600 throughout most of June and July.

In light of these developments, it is not surprising that the gold bugs are bullish again, anticipating major increases in the price of their favorite precious metal. And this time they may be right. Then again, they may be dead wrong. As CGF warns, the large mobile funds that have been moving rapidly into gold "can be withdrawn just as rapidly." According to a leading British gold expert, if market participants ever decide that the United States is getting inflation under control—not an impossibility if the Federal Reserve maintains a tight grip on the stock of money—the price of gold could "drop like a rock."

The economics of the gold market

Thus, arguments can be marshaled to support the prediction of either a rising trend or a falling trend in the price of gold. In fact, from the point of view of economic analysis, there is evidence that the gold market has evolved to the stage where, at any given time, the two possibilities are equally likely to occur. As in the case of most investment vehicles that attract professional participants, each day's market price reflects an informed consensus. Based on all information available to participants, the market price is probably the best possible assessment of the "intrinsic" market value of gold on that day. New information on succeeding days will change that market estimate, but the odds are precisely 50-50 for a price movement in either direction.

Gold prices not only go down as well as up, but they fluctuate violently and rapidly. Inherent in the nature of the gold market are both unpredictability and high volatility. There are at least four major characteristics that give the gold market its peculiar flavor:

- *Rationality.* The mystique of gold as the world's "ultimate store of value" has led some observers to designate the gold price as a barometer of world anxiety, driven by the pressures of mob psychology or speculative fever. But supply and demand still prevail, and the price of gold reflects sound economic considerations. Contrary to assertions that the gold price moves "irrationally," recent research findings support the view that investors act rationally to maximize their expected net returns from their gold dealings.
- *Duality.* Unlike most other commodities, gold can be supplied more readily from existing stocks than from current production. In fact, compared with the enormous value of "above-ground" stocks, one year's newly mined gold is insignificant. Although changes in the flow of new gold can have a major impact on gold prices—owing largely to the small size of the gold market—these effects can easily be overwhelmed by events triggering the release of supplies from existing stocks. Similarly, while the demand for gold for industrial, ornamental, or coinage uses is important, it can easily be submerged by a shift in gold demand for hoarding, speculation, or investment.
- *Thinness.* The combined value of all privately and publicly held gold is only a tiny fraction of the world's total wealth. Increasing amounts of highly mobile investment funds are finding their way to the gold market, which cannot absorb these huge flows without large swings in price.
- *Efficiency.* Like the markets for listed equities and other securities, the gold market can be characterized as economically "efficient," in the sense that it quickly processes new information and incorporates it into the price without delay. Information relevant to the price of gold each day includes all known events and data that might affect either current or anticipated gold supply and demand. Thus, market expectations of *future* developments play a key role in determining the *current* price of gold.

These four qualities provide the key to both the volatility and the unpredictability of the gold market. The market's *rationality* indicates that supply and demand will be the basic moving forces. But its *duality* means that existing stocks as well as new flows are relevant to current supply and demand. The large potential demand for stocking gold and the huge size

Efficient Markets and the Price of Gold

(continued from page 7)

of existing supplies create the potential for strong, sudden fluctuations in market supply and demand. Moreover, the *thinness* of the gold market ensures that these fluctuations will elicit price responses that are disproportionately large. Finally, the market's *efficiency* implies that it reacts not only to current supply and demand but to expectations of future changes in the determinants of these market forces. It is this property that makes gold price movements so difficult to forecast with any consistency.

Implications of market efficiency

To economists, an efficient market is one in which a great many rational profit maximizers actively compete, making full use of relevant current information that is almost freely available to all participants. They all attempt to predict future market values, including in their calculations the expected returns, discounted to their present value, from the anticipated effects of all current and expected events. "New" information—events and data that were not previously anticipated—is quickly discounted and reflected in the price.

New information is inherently random, since if it were systematic or predictable, it would already have been incorporated into the price. The market price can therefore be considered to be an "unbiased" estimate of the intrinsic value, and as new information is digested by the market, the price will wander randomly around this value. The intrinsic value may also change from day to day, and market estimates will usually be wrong. But the errors will be unsystematic —that is, they are just as likely to be too high as too low. Since the price already reflects current information and since new information is as likely to have a positive effect as a negative one, each succeeding price change is uncorrelated with the previous one. Therefore, the price on any given day is equally likely to go up or down.

Recent economic research suggests that this idealized description of an efficient market is a fair approximation of the actual behavior of the gold market—with the added proviso that, in the United States, prices of gold futures contracts provide an implicit forecast of gold price movements. The spread between spot and futures prices—and between prices of futures contracts with different delivery dates—reflect forgone interest earnings and other costs to investors of storing gold. Statistical tests performed at the Federal Reserve Bank of Richmond support the contentions that available information is rapidly discounted into the current price of gold, that successive price changes tend to be uncorrelated, and that futures prices show no systematic bias in predicting future spot prices. In short, these tests indicate that the gold market is indeed efficient, with the price moving in response to profit-maximizing actions by rational investors.

Market participants respond, in turn, to anticipated changes in the determinants of gold supply and demand. In keeping with the duality of the gold market, these determinants are of two kinds: current supply and demand flows, and political and economic uncertainty. The large price swings of the past year have stemmed mainly from the latter category, as changing perceptions of the likelihood of war, inflation, and currency depreciation have triggered massive movements of gold into and out of individual hoards.

In the absence of these large transfers, the thinness of the market ensures that the price of gold will be highly sensitive to changes in basic gold flows, as detailed in the table below. For the individual investor, however, it will be of little use to track these flows closely. In keeping with the principles of market efficiency, it is virtually certain that informed expectations of future changes in the flows have already been discounted and incorporated into the current price.

Ronald A. Krieger

GOLD FLOWS

(1970-79)

Components of Supply
(metric tons)

	Non-Communist mine output	Net trade with Communist bloc	Net official sales (purchases)	Total
1970	1,274	(3)	(236)	**1,035**
1971	1,236	54	96	**1,386**
1972	1,184	213	(151)	**1,246**
1973	1,121	275	6	**1,402**
1974	1,007	220	20	**1,247**
1975	954	149	9	**1,112**
1976	969	412	58	**1,439**
1977	972	401	269	**1,642**
1978	980	410	362	**1,752**
1979	962	229	574	**1,765**

Components of Demand
(metric tons)

	Total fabrication			Net private bullion purchases (sales)	Total
	Carat jewelry	Official coins	Other		
1970	1,066	46	264	(341)	**1,035**
1971	1,064	54	270	(2)	**1,386**
1972	999	63	282	(98)	**1,246**
1973	518	54	288	542	**1,402**
1974	225	287	223	512	**1,247**
1975	523	251	209	129	**1,112**
1976	935	185	264	55	**1,439**
1977	1,003	146	271	222	**1,642**
1978	1,007	288	301	156	**1,752**
1979	737	290	288	450	**1,765**

Data: Consolidated Gold Fields Ltd.

CHASE

International Finance

Vol. XV, No. 16
August 4, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

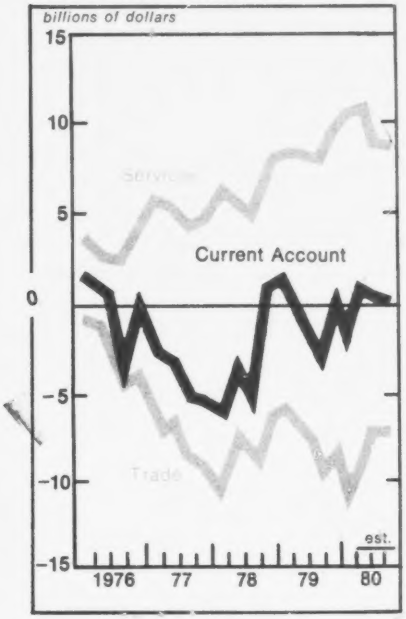
8/4/80 B 1900 - 1 U

The next issue of International Finance *will appear on September 1, 1980.*

The U.S. Current Account Moves Toward Surplus

The U.S. balance of merchandise trade—in deficit for seven of the past ten years—will register another large negative number this year. In view of the current world economic outlook, U.S. merchandise imports in 1980 are likely to exceed exports by approximately $31 billion on an f.a.s. basis (balance-of-payments definition), up slightly from the $29.5-billion deficit of last year. Had there been no major improvement in the balance of trade in non-oil merchandise, the deficit would have been much larger. Higher prices will boost the U.S. oil import bill in 1980 by about $30 billion over last year. Next year should also show a major trade deficit, probably larger than this year's, although forecasting this variable is highly sensitive both to international growth scenarios and OPEC pricing behavior.

U.S. external account balances



These merchandise trade statistics reflect only part of the picture of U.S. current international transactions, however. The United States exports and imports services as well as goods, and here the record is radically different. The U.S. balance on services and investment income—the "invisibles" account—is in substantial surplus, and the size of this surplus has been growing rapidly. Since 1975, services and investment income has been growing 50% faster than the value of merchandise exports. Last year, the "invisibles" surplus exceeded $35 billion. This year, despite the slowdown in the growth of foreign earnings of U.S. business, it could reach $39 billion.

Because of this improvement in the invisibles balance, the United States should register a surplus on current account of about $2 billion this year, the first since 1976. Those who point to the deficit on merchandise trade as a "national disgrace"—considered to be evidence of the need for protectionist action—would do well to take a closer look at the overall current account. The improvement in the U.S. current account this year is in sharp contrast to the significant increase in the current-account deficits of Germany and Japan. Indeed, in the minds of some foreign observers, if there is any "national disgrace" it is not the U.S. trade deficit but the emerging U.S. current-account surplus. In their view, such a surplus demonstrates that the United States is not fulfilling its role in facilitating adjustment of the oil-importing countries to the OPEC surplus.

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Pressures for reflationary policy mount as the French economy slows.

The French economy is moving into recession. Weakening household consumption since the beginning of the year is now being reflected in increased stock levels and a deteriorating business climate. Industrial production fell by 2.2% in May and is expected to contract by at least another 5% by yearend. Official projections of real GDP growth of 2.5%-2.7% for 1980 are likely to prove optimistic. Growth of 1.5%-2% is more probable, despite a high level of industrial investment. The imminent recession poses a dilemma for the French authorities. Rising unemployment is leading to mounting pressure for reflationary policies. But the economy is slowing sooner than in neighboring Germany, and an early relaxation of monetary policy would lead to downward pressure on the franc—which would heighten inflationary pressures. The most likely course is for the authorities to lag any change in the German Bundesbank's monetary policy. This would provide scope for a lowering of interest rates and inflation at yearend. In the interim, selective measures will be adopted to support depressed sectors of industry.

Austria's widening current-account gap prompts fiscal tightening.

Austria's deteriorating external position has led the authorities to propose tighter fiscal measures. The current-account deficit for the first four months of 1980 totaled 15 billion schillings, twice the year-earlier figure, and the deficit for all of 1980 is expected to reach at least $3 billion, as compared with $2 billion in 1979. The Government is now seeking to hold the public-sector deficit (excluding debt repayments) to 3.1% of GNP this year and reduce it to 2.5% of GNP in 1981. To this end, the authorities plan to cut back subsidies, raise postal and telephone charges and other public-sector service prices, and boost indirect taxes and social security charges. The authorities may also have to raise interest rates further to prevent pressure on the mark-tied schilling, whose position would stand to be bolstered still further by the anticipated reduction in German interest rates in August or September.

Finland's brisk economic growth has raised concerns about overheating.

Finland's economy grew very rapidly in the first quarter of 1980, posting a 5.5% annualized rate of growth. The Government and central bank have accordingly revised their forecasts upward and are now anticipating a GDP growth rate of more than 6% in 1980, with the growth in industrial production expected to exceed 7%. Such a healthy pace of economic growth will place Finland well ahead of all other European countries. But there is mounting concern that the domestic economy will overheat and trigger an acceleration in the inflation rate, which is now running at slightly over 11%. In addition, economic slowdowns in its trading partners are threatening Finland with a growing trade deficit. The January-June deficit reached 2.15 billion markkaa, in contrast with a 1.32-billion markkaa surplus for the same period last year. Some corrective action has been taken. The Bank of Finland tightened domestic credit in May, and the 1981 budget plans announced in June aim to postpone public-sector investment and remove some liquidity from firms in the private sector by freezing a portion of their earnings in a special fund.

Australian inflation outlook improved by moderate wage grants, but uncertainty persists.

The Australian economy appears well positioned against the slump in the U.S. and European economies. The country's real GDP grew 4.8% in 1979, owing primarily to the relative competitiveness of labor and strong investment. By current world standards, economic growth is expected to continue reasonably buoyant through 1980, with annual real growth estimated at 2.5%. The key uncertainty on the horizon is the outlook for wages and prices. Inflation is now running about 10%-11%, year over year, and the rate may drop steadily in 1981, barring an unfavorable conclusion of the annual wage bargaining process. The Australian system of wage fixing is centralized, with responsibility vested in an independent

Arbitration Commission. While the Commission fueled inflationary pressures in 1974-75 with its wage grants, it has held the line on increases in recent years. Recently, the Commission granted workers a 4.2% increase for the next six months, implying a less-than-perfect cost-of-living adjustment; it also postponed consideration of a shorter work week as proposed by the metal workers. These decisions should leave the Government's anti-inflation policies intact, but further lobbying by labor for sharply higher wages cannot be ruled out.

Austerity measures needed to ease Costa Rica's worsening external-payments position.

Costa Rica's balance of payments has deteriorated steadily over the past several years. The country's current-account deficit widened to $600 million in 1979 from $225 million in 1977, or from 7% to 14.5% of GDP. In an effort to improve its external-payments position, the Costa Rican authorities introduced in the first quarter of 1980 an economic stabilization plan within the context of an IMF standby program. But the Congress' failure to approve certain austerity actions, including tax measures, prevented compliance with the IMF program's required targets for credit growth to the public and private sectors. Nonetheless, the country's precarious foreign-exchange position—end-April reserves of $80 million were sufficient to cover only three weeks of imports—means that if Congress continues to oppose the needed measures, the Government may ultimately be forced to introduce exchange-rate adjustments, foreign-exchange controls, or import quotas.

Iraqi oil revenue will approach $35 billion in 1980.

Iraq has now taken Iran's place as OPEC's second largest producer and exporter of oil. Oil production, which averaged only two million barrels per day in the mid-1970s, averaged some 3.5 million barrels daily in the January-May period, with exports of about 3.3 million barrels. Iraq is not regarded as an OPEC price hawk, but it has nonetheless followed the OPEC line by boosting the price of its Basrah 34 light oil to $31.96 effective July 1, a price that yields a premium of $4 above comparable Saudi grades. Oil revenue for 1980 is currently projected at about $34.5 billion. Despite a stepped-up import program, a current-account surplus of approximately $20 billion is anticipated for 1980 as a whole. Such increased oil earnings and surpluses are rapidly transforming Iraq into a major financial power, and the country's rising import expenditures are making it the fastest growing market in the Middle East.

Despite the prospect of another bumper crop, cotton prices are likely to remain strong.

Enticed by strong export markets and high prices at planting, the world's cotton growers may produce another bumper crop in 1980-81. Despite a blistering heat wave and drought in the prime cotton-producing regions of the United States, the world's largest producer, the U.S. Department of Agriculture is predicting that total world cotton production in the coming year will range between 64.1 million and 66.1 million bales—largely because of an anticipated increase in non-U.S. output. Initial tallies for the 1979-80 market year, which ended July 31, place worldwide production at 65.6 million bales, more than 9% higher than the 1978-79 yield. World cotton consumption in 1979-80 reached a record 64.9 million bales, more than 3% higher than the previous year. Record purchases from the United States by China, as well as strong demand in other Asian markets and in Europe, helped push world cotton exports to unprecedented heights. Cotton prices have retreated recently from their February peak, but they are still well above year-ago levels. And they are likely to remain strong in the coming year, given the current, relatively firm world demand. Some cyclical weakening of demand is expected in many industrialized countries, and textile manufacturers are already reporting a slackening of orders. But increased cotton demand by the developing nations should keep world consumption in 1980-81 roughly equivalent to that of the past year.

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Fed Sets Money Growth "Targets"

Federal Reserve Chairman Volcker provided rough estimates of the Fed's 1981 target growth ranges for the monetary aggregates last week, after initially declining to do so before Congress on July 22. Chairman Volcker's subsequent communication to the Congressional Banking Committees reflected two basic concerns about estimating monetary growth targets. First, it is difficult to estimate on an *a priori* basis the effect that the introduction of NOW accounts on a nationwide basis next January (included in M_{1b} but not in M_{1a}) will have on the behavior of the narrowly defined aggregates. Second, the Federal Reserve believes the relationships among the monetary aggregates, income, and interest rates have shifted recently and that these relationships are subject to a significant degree of uncertainty over the next few years.

Putting aside these two concerns, Chairman Volcker indicated the Federal Reserve wished to reduce the 1981 target growth ranges for M_{1a}, M_{1b}, and M_2 by ½ percentage point from the 1980 target ranges—or to 3%-5½%, 3½%-6%, and 5½%-8½%, respectively. However, owing to the effect of nationwide NOW accounts, the actual 1981 target growth ranges for M_{1a} and M_{1b} consistent with the above are estimated to be 0%-2½% and 5%-7½%, respectively.

Chairman Volcker also noted that these ranges imply continued efforts by the public to economize on money balances. There is a belief at the Federal Reserve that the demand for money shifted downward during the first half of 1980. The Fed contends that this shift—not just high interest rates and a slowing of nominal GNP—contributed to the shortfall in money growth relative to targets. But clearcut evidence for money demand shifts is difficult to discern and is acquired retrospectively. Thus, money growth in relation to targets may possibly be subject to *ex post* reinterpretation based on imputed behavior of the public. This leaves open the prospect that deviations in the future from Federal Reserve targets could be viewed as arising from changes in public behavior, and not from errors in the conduct of monetary policy.

Widespread discussion of this important issue appears likely in coming months. The Federal Reserve seems to be saying that the relationship between the monetary aggregates that it targets and total spending—and thereby real growth and inflation—is, and will probably continue to be, highly uncertain. It is also saying that this uncertainty reflects, but is not solely, the result of institutional or regulatory changes. One of the governors of the Federal Reserve recently concluded that when such uncertainty exists "money growth is . . . no longer a reliable guide to monetary policy." If this is how the Fed will be viewing things in the coming year, then the obvious question that emerges is: What, if anything, *is* a reliable guide?

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE			
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Asia	**Bangladesh**	Industrial growth target of 9% set for fiscal 1980/81.	Feb.	+ 31%	8.9	$ 103	May	276	— 23%	1.6
	Burma	Economic conditions improving as Government introduces greater market incentives.	Feb.	+ 66%	4.3	128	May	279	+ 45%	9.3
	China, People's Republic	Joint-venture projects between Western and Chinese interests beginning to materialize.	Mar.	+ 37%	515.0	510	June '79	3,538	+ 11%	3.0
	Hong Kong	Exports dampened by U.S. recession, but financial and property sectors continue expanding.	Mar.	+ 36%	16.6	3,320	n.a.	—	—	—
	India	Greater scope for private-sector activity likely to continue, despite Sanjay Ghandi's death.	Mar.	— 20%	121.1	188	Apr.	6,967	— 3%	7.3
	Indonesia	Economy strengthening, paced by a dynamic export sector.	Dec.	+ 35%	43.4	289	May	5,014	+ 54%	8.3
	Japan	Consumer demand is weakening	Apr.	+ 22%	948.0	8,243	May	20,651	— 12%	2.0
	Korea	GNP growth of just 2% expected this year, but political situation is stabilizing.	Apr.	+ 20%	61.1	1,624	Apr.	2,513	— 6%	1.3
	Malaysia	Strong exports will fuel GNP growth of 7%-8% in 1980.	Nov.	+ 41%	17.3	1,310	Mar.	3,725	+ 7%	5.9
	Nepal	Strong new government may tackle economic and trade problems more effectively.	Mar.	— 44%	1.5*	114	Apr.	177	+ 18%	7.7
	Pakistan	Improvement in exports will raise economic growth rate to 6% this year.	Apr.	+ 58%	20.9	265	May	875	+105%	2.3
	Philippines	Unfavorable terms of trade and export recession hurting real national income.	Feb.	+ 35%	29.1	612	May	2,454	+ 23%	4.2
	Singapore	Commercial and industrial activity expanding briskly; 8% economic growth likely.	Jan.	+ 51%	8.9	3,703	Feb.	5,953	+ 10%	3.8
	Sri Lanka	Industrial production affected by power shortage; inflation rate of 35% expected this year.	Dec.	+ 17%	3.1	206	Apr.	429	0	2.7
	Taiwan	Moderate growth of 6% expected this year in view of export weakening.	Feb.	+ 29%	27.6	1,623	Mar.	1,509	+ 5%	1.2
	Thailand	Rain has washed away fears of drought-related economic problems; 6%-7% GDP growth expected.	Feb.	+ 43%	26.0	565	May	2,132	— 1%	3.4
Oceania	**Australia**	Investment in primary-resource sector growing fast as foreign firms rush in.	May	+ 21%	124.0	8,551	May	1,918	— 13%	1.2
	New Zealand	Economic prospects remain bleak, with limited growth potential for meat and dairy products.	Mar.	+ 16%	15.4	4,812	Apr.	529	— 10%	1.3

*1978

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Claims of Recession's End Unfounded

Improvements in a few economic indicators for the month of June have led some analysts to speculate that the end of the U.S. recession is in sight; others have claimed that it has already ended. June retail sales rose 1.5% after four months of steep declines; housing starts jumped 30%; and the index of leading economic indicators rose 2.5%–the first increase in a year. These are tender reeds, however, on which to base the claim that a recovery is under way, as there is strong evidence that further economic weakening is likely.

Most attention about the recession so far has been focused on the household sector, and logically so, since consumer spending and residential construction account for about 70% of GNP. In contrast, spending by businesses accounts for only about 10% of GNP. Business expenditures, however, tend to be far more cyclically responsive than consumer expenditures. Indeed, during the last five recessions, the peak-to-trough decline in real GNP averaged about 3%; personal consumption fell an average of 1%; while the declines in business fixed investment–excluding even more volatile inventory changes–averaged nearly 10%.

This drastic difference in consumer and business behavior during past recessions is mainly the result of the different performances of personal income and corporate profits. Nominal personal income did not fall at all in the last three recessions, and it declined by less than ½% in the recessions of the 1950s. Despite rising prices and the varying severity of these five recessions, however, corporate operating profits before taxes (excluding the effects of inventory profits and depreciation) consistently declined by about 20%.

The 2¼% decline in real GNP in the second quarter of 1980 represents a larger drop than occurred in two of the last five recessions. And significantly, most of the weakness was attributable to the household sector: real consumer spending plummeted $23 billion and real residential construction dropped nearly $11 billion. Business spending for plant and equipment in constant dollars, on the other hand, fell about $7 billion.

Plunging profits, as well as historical evidence, suggest that business expenditures can be expected to fall another $5 billion or so, even without any further cutbacks in the household sector. But a rising unemployment rate, slow gains in personal income, and still-high inflation rates suggest that real personal consumption will probably continue to fall, albeit at a much slower rate. Furthermore, the rapid decline in sales sent the ratio of inventories to sales soaring in the spring. Even if sales pick up modestly in the months ahead, businesses can be expected to sell off some of their inventory, leading to further cutbacks in production and increasing unemployment. Thus, while the worst part of the recession in the United States may have passed, further weakening will characterize the U.S. economy throughout the year.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
of IMF dit, mil- of dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	July 30, 1980		current monetary conditions	
173	Consortium aid commitments for FY 1980/81 held to $1.35 billion.	Mar.	+17%	Feb.	+20%	—	.0710	Money supply remains tight.	**Bangladesh**
67	Improved harvest will reduce the trade deficit.	Feb.	+ 4%	Sept.	+15%	—	.1580	Black market rate of kyat falling.	**Burma**
0	Trade deficit may approach $1 billion this year.	n.a.	—	—	—	—	.7200	First World Bank loan expected soon.	**China, People's Republic**
—	Investment inflow will help offset large trade deficit.	Mar.	+18%	Mar.	+43%	—	.2020	Money market is highly liquid.	**Hong Kong**
0	Trade gap may reach $4 billion in 1980.	Mar.	+12%	Feb.	+23%	9.00%	.1290	Credit is restrictive.	**India**
0	Current-account surplus of $1.5 billion expected this year.	May	+19%	Nov.	+11%	—	.001625	Monetary policy remains restrictive.	**Indonesia**
0	Trade balance in 1980 will be bolstered by strong exports.	Apr.	+ 8%	Apr.	+10%	9.00%	.0045	Discount rate cut expected by early September.	**Japan**
335	Trade deficit will exceed $5.5 billion in 1980.	Apr.	+26%	Apr.	+39%	21.00%	.0017	Credit policy eased to aid ailing industries.	**Korea**
0	Current account will show another large surplus this year.	Apr.	+ 6%	Feb.	+15%	—	.4650	Pressure to boost prime rate easing.	**Malaysia**
11	Trade deficit to widen, owing to oil imports.	Mar.	+17%	Dec.	+21%	—	.0855	Money supply expanded 15% in 1979.	**Nepal**
415	Trade deficit could reach $2.5 billion in fiscal 1980/81.	Apr.	+12%	Mar.	+18%	10.00%	.1450	Monetary policy continues anti-inflationary.	**Pakistan**
746	Trade deficit for 1980 projected at $2.5 billion.	Mar.	+25%	Mar.	+21%	6.00%	.1365	Credit is restrictive.	**Philippines**
0	Heavy imports of investment goods will widen trade gap.	Mar.	+11%	Feb.	+39%	—	.4710	Money market rates easing.	**Singapore**
290	Trade deficit may exceed $400 million this year.	Mar.	+28%	Nov.	+27%	12.00%	.0635	Monetary policy is restrictive.	**Sri Lanka**
0	Trade deficit may exceed $500 million this year.	Mar.	+17%	Feb.	+19%	14.00%	.0290	Loan demand strong, despite high interest rates.	**Taiwan**
239	Foreign direct investment increasing, despite border troubles.	Mar.	+21%	Oct.	+28%	13.50%	.0505	Interest rates held high in support of exchange rate.	**Thailand**
243	Mineral exports will push 1980 trade surplus over $2 billion.	Mar.	+11%	Mar.	+12%	—	1.1560	Money market conditions continue tight.	**Australia**
285	No relief in sight for payments problems.	Mar.	+18%	Mar.	+19%	13.00%	.9800	Interest rates kept high to fight inflation.	**New Zealand**

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World Interest Rates

market rates of July 30, 1980; bond yields as of July 25, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	10.18	16.00	13.00	9.50	7.50	15.00* penalty rate 18.00	9.00	3.00	9.00
Day-to-Day Money	9.75 July 31	12.00	16.50	11.75	11.75	9.55	16.875	9.875	2.00	12.8125
Treasury Bills 91-day, Middle Rates	8.37	9.90	14.4375	13.00	11.77 one-year	n. a.	15.25* 160-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.375 finance paper	10.50 finance paper 15% tax w/h	13.79	13.10 Certified	11.8125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	10.45 15% tax w/h	14.875	12.90 Certified	not traded	9.90	20.20*	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.31	11.80	12.50	10.10 20% tax w/h	12.90	7.82	15.45*	9.41	4.59	8.50
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	13.58	13.38	13.91	13.77	7.96	15.65	10.31	5.47	7.35
Bank Short-Term Rate to Best Borrowers (prime rate)	10.75	12.25	17.00	17.00	14.60	11.50	19.625*	12.00	5.50	9.25
Bank Time Deposits 3-month	8.50 Cert. of Dep.	10.45 Cert. of Dep.	15.5625	13.00	11.8125	9.00	10.75	9.625 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.625	no market	16.9375	no market	12.00	8.50	no market	9.5625	5.4375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8625	2.3460	.0351	.2425	.5618	.001190	.5151	.6064	.004410
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.75 *D*	6.375 *D*	2.625 *D*	2.50 *D*	1.375 *P*	16.625 *D*	.125 *P*	4.25 *P*	3.125 *D*

Eurodollar Deposits

(London, interbank, bid)
July 31

7-day	9.3125
1-month	9.4375
3-month	9.75
6-month	10.00

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .50
U.S.-Canada Treasury Bills	− .41
U.S.-Canada Finance Co. Paper	−1.23
Eurodollars-U.K. Local Auth. Deposits	+ .18

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.625
Over 7 yrs.	12.00
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	7.875

Gold Price

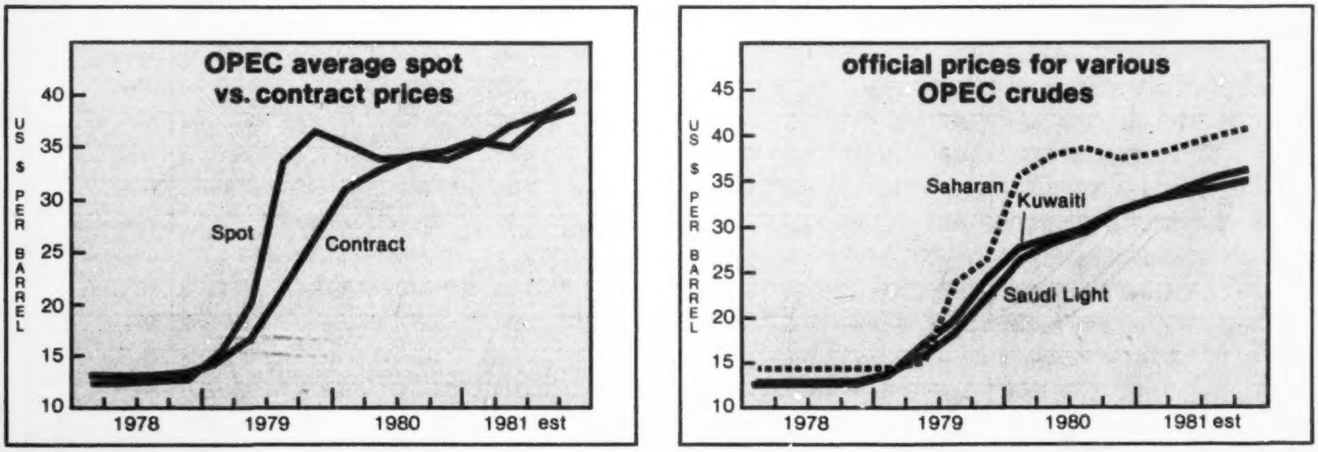
London
afternoon fixing

629.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of July 23; bond yields as of July 18.

OPEC Price Trends



OPEC and the World Energy Outlook

Demand for OPEC oil has weakened considerably in response to the sagging growth in world energy demand, halting the dizzying pace of oil price rises of the last 18 months. With world oil demand now running some 3-4 million barrels per day less than last year, official contract prices have stabilized and the spot market has all but dried up.

Free world energy demand is expected to drop from 98.5 million barrels of oil equivalent per day in 1979 to 97.8 million barrels daily in 1980. This represents a decline of 0.7%, in contrast with an increase of 4.3% from 1978 to 1979. The two fundamental causes are: the economic recession in North America and the growth slowdown in Europe and the developing countries, which have dampened energy requirements; and the skyrocketing of oil prices in 1979, which has spurred more efficient energy utilization.

World Energy Outlook
(millions of barrels per day)

	1978	1979	1980	1981
Free World Demand	**94.4**	**98.5**	**97.8**	**100.3**
Non-Oil Supply	44.1	45.7	47.6	49.3
Non-OPEC Oil Supply	18.8	20.1	21.3	22.5
Net Communist Exports	1.0	1.3	1.2	1.0
Gap Filled by OPEC Oil	30.5	31.4	27.7	27.5

Over and above the reduced demand for all forms of energy, there has also been a shift by both consumers and industry away from oil as an energy source. The supply of non-oil energy increased from the equivalent of 45.7 million barrels per day (bpd) in 1979 to 47.6 million bpd this year. Moreover, additional oil supplies from the North Sea, Mexico, and other non-OPEC suppliers have contributed 1.2 million bpd to world supply. The net effect has been a sharp rise in world stocks of crude oil and products (to nearly six million barrels) and a large decline in the demand for OPEC oil—from 31.4 million bpd in 1979 to an estimated 27.7 million bpd this year (see table above).

OPEC oil producers may have to remove between 2.5-3.0 million bpd from the world market to balance supply and demand in the second half of 1980. The OPEC countries most likely to bear the brunt of this adjustment are Saudi Arabia, Iraq, and possibly Libya, but Venezuela and Nigeria are also good candidates for production cutbacks.

The excess supply situation has reduced spot prices significantly (see charts on bottom page 6) and has restrained the increase in contract prices. The OPEC meeting in Algiers last June set a ceiling of $32 per barrel for "marker crude"—$4 above the $28 per-barrel price currently charged for Saudi light crude, the traditional benchmark—and a maximum of $37 per barrel for the sweet African crudes. The prices of the latter were accordingly raised marginally to the upper limit, while Iraq, Kuwait, and Qatar increased their prices by $2 per barrel in line with the new benchmark level. But the soft oil market conditions induced Indonesia and Iran to hold their main contract prices constant and afforded Venezuela only a small rise in price. In the interest of restoring price stability, Saudi Arabia and the UAE have so far maintained their prices, while the Saudis are expected to hold oil output at 9.5 million bpd at least through the end of the third quarter.

OPEC Oil Production
(millions of barrels per day)

	1979	1980		1981*
		Jan.-June	July-Dec.*	
Saudi Arabia	9.3	9.5	9.0	8.5
Iran	3.0	1.8	1.5	2.0
Iraq	3.5	3.5	3.0	3.3
Kuwait	2.3	1.6	1.25	1.5
North Africa	5.3	5.3	4.4	4.5
UAE, Qatar, N.Z.	3.1	2.7	2.6	2.6
Other	4.2	3.9	3.7	3.9
Natural Gas Liquids	0.8	0.9	0.8	1.1
Total OPEC	**31.4**	**29.2**	**26.3**	**27.5**

*Forecast

The effective weighted sales price of OPEC crude oil is expected to average $31 per barrel in 1980, up 60% from the weighted average price of $19.40 in 1979 and 140% higher than the comparable 1978 price. This projection is based on certain pricing behavior patterns on the part of key OPEC members. It assumes that the Saudis raise their benchmark price by $2 per barrel before the September OPEC meeting, boosting their price to $30, and that Abu Dhabi, Indonesia, and Venezuela also increase their prices for the fourth quarter by a similar amount. It assumes further that in order to set the stage for OPEC price unification by yearend, Saudi Arabia boosts its price another $2 to $32 per barrel shortly before the December OPEC meeting, and that some of the surcharges applied to OPEC crude exports either narrow or disappear. Such developments would restore the traditional differentials between Saudi light and heavier crudes, but would leave the differentials for North African sweet crudes well above historical levels (although the prices of these crudes are expected to increase by less than the benchmark in 1981).

Looking out to 1981, world energy demand should begin to rise again, assuming a worldwide economic recovery and normal weather patterns. The rise in oil demand will, however, be slow—the growth pace is estimated at about 2.6%. But the demand for OPEC oil in 1981 is expected to be marginally *lower* than in

OPEC and the World Energy Outlook

(continued from page 7)

1980. Although a reduction in net Communist oil supplies is anticipated—with Soviet and Chinese output unable to keep up with domestic needs and Eastern European requirements—increased oil from non-OPEC sources will continue to expand, by some 5.6%. In addition, non-oil energy supplies will continue growing; the rate of increase, however, will slow from an estimated 4.2% in 1980 to 3.8% in 1981.

As for the 1981 price outlook, if Saudi Arabia is able to unify prices by the end of the year and if OPEC anticipates weak demand in 1981, a long-term price setting formula may be adopted. This formula is keyed to an average OECD growth and export inflation rate, and an exchange-rate adjustment for the dollar. Based on current projections, the formula would yield an average benchmark crude price rise of about 11% in 1981.

Current-account surplus widening again

In the wake of the first round of oil price rises, OPEC's aggregate current account posted a surplus of $64 billion in 1974. By 1978, however, the surplus was nearly gone (see table below). It shrunk to less than $1 billion, the result of sluggish world demand for oil, rapid growth in OPEC imports, and a sharp turn-up in internal OPEC oil consumption.

OPEC Current Account Surpluses (1978-81)

(billion dollars)

	1978	1979*	1980*	1981*
Merchandise Exports	134.3	206.8	281.7	307.2
net oil earnings	124.5	194.6	268.4	292.2
non-oil earnings	9.8	12.2	13.3	15.0
Merchandise Imports (f.o.b.)	−99.4	−98.0	−125.4	−160.5
Services Exports	21.1	26.1	36.8	40.0
(investment income)	(11.5)	(16.9)	(26.3)	(28.5)
Services Imports	−45.7	−51.6	− 65.4	− 83.8
Transfers	− 9.4	−12.4	− 15.2	− 17.5
(Official)	(− 5.7)	(− 7.6)	(− 9.1)	(− 10.0)
Current-Account Surplus	**0.9**	**70.9**	**112.5**	**85.4**

*Estimated

Last year saw the surplus reemerge. In fact, it swelled to an estimated $71 billion, reflecting three important influences. First, OPEC oil output (excluding natural gas liquids) rose 3½%. Second, not only did official contract prices surge in 1979, but a large volume of oil was sold on the spot market, or at spot-related prices, particularly in the second half of the year. Total OPEC oil revenue, as a result, jumped 56% to $195 billion, on a net earnings basis. And third, OPEC imports of non-military goods dropped by about $1 billion to $98 billion (f.o.b.), owing to a sharp fall in Iranian purchases and slower growth of aggregate imports of other OPEC nations.

In 1980, OPEC imports of goods and services (including military) are expected to grow much faster. Merchandise imports alone are projected to jump 28% to over $125 billion, reflecting the expansionary development budgets being implemented by several OPEC nations. But despite this spurt in OPEC expenditures, the aggregate surplus on current account will widen to approximately $112.5 billion this year (after official transfers of $10 billion). The major reason is a projected increase of 38% in net oil revenue to $268 billion, based on an average oil output for the year of 26.9 million bpd (excluding natural gas liquids) and on the price scenario outlined earlier. Investment income generated by foreign assets will also contribute significantly to the 1980 surplus. Such inflows are estimated to increase to $26 billion from about $17 billion in 1979. The OPEC members likely to see the largest surpluses this year are Saudi Arabia, Iraq, Kuwait, and the UAE (see table below).

Current Accounts of OPEC Members (1977-80)

(billion dollars)

	1977	1978	1979*	1980*
Saudi Arabia	12.8	0.8*	15.3	40.4
Kuwait	4.8	6.2	14.2	16.1
UAE	2.9	2.6*	6.7	12.2
Iraq	4.6*	4.0	13.0	19.6
Iran	5.1	−0.7*	11.7	0.9
Qatar	0.3*	0.9*	2.0	3.2
Algeria	−2.3	−3.5	−0.8	0
Libya	2.9	1.8	6.0	9.1
Nigeria	−1.0	−3.8	3.0	7.2
Gabon	−0.1	0.1	0.5	0.8
Indonesia	−0.1	−1.5	1.2	1.6
Venezuela	−3.1	−5.4	−1.5	1.8
Ecuador	−0.3	−0.6	−0.4	−0.5
Total OPEC	**26.4**	**0.9**	**70.9**	**112.5**

*Estimated, accrual basis

For 1981, the OPEC surplus is projected to decline to about $85 billion. This expectation is based on an estimated 9% increase in net oil revenue, with production down slightly from 1980; the adoption by OPEC of its long-term pricing formula; and 28% growth in imports.

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CHASE

International Finance

Vol. XV, No. 17
September 1, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

9/ 20/

B 1980. 1 1)

Prospects Brighten for Earlier U.S. Recovery

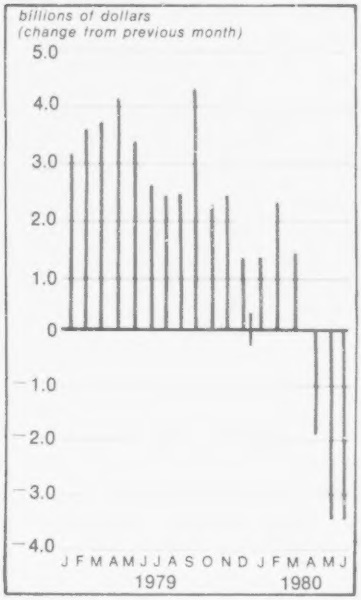
The economic recession in the United States is continuing. But the rate of decline is currently much slower—probably less than half the 9% annual rate of descent in real GNP that was recorded in the second quarter. Furthermore, there is now growing evidence of developments that could lead to an end to the recession in the reasonably near future.

The precipitous fall of interest rates in the late spring and early summer brought a rebound in construction of new housing in June and July. By May, starts on new housing units had fallen by more than 50% in just over a year. The more recent rebound of interest rates will prevent further improvement for a while, but the decline has been arrested. At the same time, consumer spending has improved in real terms after a very bad spring. Purchases of automobiles reached a low annual rate of 7.4 million units in May, 30% below the total for 1979. The rate of sales has since recovered about one-third of that loss. Consumer purchases of other goods have also begun to turn up modestly. And American consumers reduced their outstanding installment debt by record amounts—$8½ billion in the second quarter of the year. That paydown of debt means that consumers will be better positioned to use new credit in support of a rising rate of spending in the future.

Perhaps most importantly, American business has already made progress in adjusting inventories to the new, lower rate of final demand. In real terms, inventories were cut in May and in June. Preliminary indications for July imply another reduction. Inventory corrections usually come late in a recession, when they tend to extend and deepen the economic decline. This unusually early start on inventory adjustment suggests that the current recession—while certainly a deep one—could be fairly brief. A growing number of forecasters now foresee an upturn beginning before the end of 1980.

The zero rate of increase in the Consumer Price Index in July was also a welcome development. Little recovery in consumer spending would be possible as long as the 15% rate of inflation of the first half of the year was sustained. However, while it is unlikely that prices will return to their former rate of increase, the mid-summer lull is clearly temporary. Food prices are already rising faster. And the demand weakness that moderated the upward trend of energy prices is likely to be temporary. Excluding the effect of such transitory developments, the United States still has an underlying inflation rate of 8%-10%, an uncomfortably high base from which to begin an economic recovery.

U.S. consumer credit outstanding



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U.K. Government remains committed to tight money policy, despite slip into recession.

Since its election in May 1979, the U.K. Government has sought to curb inflation with a restrictive monetary policy. But the policy has done little to stem the rise in earnings and prices, which are now climbing at some 21% and 17%, respectively. This has led firms to trim output and employment, and the economy is sliding into its worst recession since World War II, with a GDP decline of about 2% anticipated for the year. This situation has heightened tension between government and labor. The Government maintains that it will stick to its monetary policy, implying that labor will have to consent to lower wage settlements to preserve job security. Labor, however, is banking on the Government's backing off and boosting its money targets to accommodate large settlements. The situation has been clouded by the record 5% rise in the money supply in August. Much of the increase results from a change in reporting procedures and does not constitute an actual increase in credit supply. (It does indicate, however, that the old reporting procedures understated the size of the money stock, making the Government's money policy appear tighter than it really was.) Financial analysts now believe that if the Government seeks to remain firm, it will have to maintain tight money conditions longer than previously expected. They thus see little scope for interest rate reductions in the near future and expect to see sterling remain strong on the foreign-exchange markets.

Weakened German economy speaks for easier money stance, but DM concerns persist.

Evidence is mounting that the German economy is in recession. Industrial production in the second quarter fell at a seasonally adjusted annual rate of 10.5%, compared with the first quarter, and the June figure was 1.6% below its year-earlier level. Industrial order volume also declined in the second quarter, and surveys show a marked deterioration in the business climate. Although import volume has been falling since February, unfavorable movements in Germany's terms of trade have widened the current-account deficit to DM 12.3 billion in the first half of 1980, versus DM 10 billion for all of 1979. These developments present the monetary authorities with a problem: Domestic considerations clearly point to a relaxation of monetary policy (the money stock is growing at the bottom end of its target range), but the large current-account gap has heightened concern that any reduction in interest rates will weaken the mark on foreign-exchange markets. Still, a slight relaxation has occurred, as DM 5.4 billion was made available to the money market in July for one month, which will be effectively replaced by the newly announced 10% cut in reserve requirements on banks' domestic and foreign liabilities. As the recession gathers steam, however, the authorities will be increasingly likely to take domestic economic considerations into account, and further interest rate declines are therefore probable.

Canadian economic slowdown unfolding, but decline expected to be moderate.

The Canadian economy appears to be weakening, but there is little evidence that the overall output decline will be steep. Industrial production and real GDP have fallen in recent months, but the reductions have been moderate. Also, employment increased in June, and the July joblessness rate dropped to 7.6% from 7.8% in June. Inflation, on the other hand, rose to a rate of 10% in both June and July after running in single digits since the end of 1975. The reasons are higher costs for food, fuel, and housing. For some sectors of business, these higher costs are shrinking profit margins and pointing to a probable business recession for the year, and the housing and automobile sectors have already suffered large declines. Nonetheless, Canada's foreign trade surplus has held up surprisingly well, in light of the U.S. recession. And the future plans of business remain relatively optimistic, with spending surveys indicating a 21% increase in plant and equipment expenditures for the year. Together, these diverse and often conflicting trends suggest either a zero or a slightly negative real GNP growth rate for 1980, down significantly from the 1979 positive rate of 2.7%. Canadian inflation, however, is expected to remain in the 10% range, primarily the result of planned increases in the internal price of domestically produced oil.

High oil bills for Greece necessitate restrictive policies; inflation has still to respond.

The 1979-1980 oil price rises are proving very costly for the Greek economy. Last year, Greece's oil bill rose by some $800 million, and a further $650-million rise to some $2.5 billion is expected for 1980. Although the authorities tightened monetary and fiscal policies late last year, the country's current-account deficit—projected at over $2.5 billion for 1980—will still exceed the $2.3-billion gap of 1979. Tighter policies are expected to preclude any real economic growth this year, with public and private investment set to decline sharply. But inflation has yet to respond. During the first five months of 1980, consumer prices rose at an annual rate of 28%, which was 25% higher than their year-earlier level. In an attempt to sustain the competitiveness of Greek exports, the authorities devalued the drachma by about 14% over the first five months of the year, accepting the consequent rise in import prices. If competitiveness is to be maintained in the longer term, however, Greece must prevent the rise in import prices from being translated into higher labor costs.

Malaysian economic advance slows, but five-year-plan growth target may well be met.

The Malaysian economy experienced broad-based growth in 1979, posting real GNP growth of 8.5% and consumer price inflation of only 3.6%. Economic advance last year was driven by strong export earnings, firm demand for residential and commercial property, buoyant investment, and rapid increases in public spending. The economy is not expected to perform as well this year. The slowdown in world economic activity has dampened export growth and has temporarily curbed manufacturing investment. At the same time, the country's inflation rate has risen; it is now running at an unofficial rate of 8%-10%. The property market, however, continues strong, and government spending is offsetting some of the slack in other segments of the economy. In all, a 7% GNP growth rate is possible for 1980, sufficient to bring the growth performance for the third Malaysian plan period (1976-1980) very close to target.

Thailand's economy enjoying strong growth, but concern over inflation is high.

The Thai economy advanced briskly in 1979, posting real GDP growth of 6.7%, down from the even stronger 11.7% pace of 1978. Despite the moderation in growth last year, inflation heated up and the balance of payments deteriorated. Consumer prices rose 9.9% in 1979, up from 7.6% in 1978, mainly the result of more costly oil imports, but also because of drought-related higher food prices late in the year. The country's trade deficit widened to $2.3 billion in 1979 from $1.4 billion in 1978, with the current-account gap widening to $2.1 billion from $1.2 billion. While the balance-of-payments performance has improved considerably in the first five months of this year, inflationary pressures have mounted. Through end-March, consumer prices had risen 7.3%, equivalent to an annual rate of over 20%. The Government responded by expanding the price controls introduced in 1979; still, the increase in prices for the month of May alone was 3.7%. The hope is that the favorable rains now under way will help ease food prices, while the stabilization of world oil prices will moderate oil import costs, leading to a decline in the inflation rate in the second half of the year.

India tackles bottlenecks in efforts to spur industrial growth.

India's real GNP declined by 3% in fiscal 1979/80 (ended March), the result of a drought-induced 10% fall in agricultural output and a 0.8% decline in industrial production. This year, abundant monsoon rains have improved prospects for agricultural production, provided that flooding does not inflict excessive damage. Industrial production, however, will remain constrained by shortages of coal and electric power and by inadequate transport. To alleviate these infrastructural bottlenecks, the Government has stepped up investment in electric power, coal, and steel and has eased import constraints somewhat to permit industry to obtain the needed inputs from abroad. In a further attempt to revitalize the industrial sector, the Government recently announced new fiscal incentives for industrial investment; it also moved to relax regulations that had restricted growth in private-sector productive capacity. While this more favorable attitude toward private enterprise offers hope for the future, infrastructural bottlenecks are likely to continue to constrain industrial growth in the near term.

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Unemployment Looks Set to Rise

The unemployment rate remained steady at about 7¾% of the labor force in May, June, and July, after a steep run-up from 6.2% in March. The pause has allowed policymakers time to assess what stimulation, if any, the economy should receive. It has enabled the Administration to continue resisting a tax cut or massive employment program and has allowed the Federal Reserve to maintain a relatively steady posture, leaving interest rates to drift upward in response to monetary growth above short-run targets. But there are some indications that the unemployment rate may soon resume its rise—and precipitate calls for corrective government action.

The first indicators of potential deterioration are the employment statistics themselves. The Bureau of Labor Statistics publishes two measures of employment, one derived from a survey of households and one from a survey of (nonagricultural) employer payrolls. These measures may deviate from each other over the course of a few months, but they generally move in tandem over the longer term. Recently, the payroll indicator has shown steeper employment declines. From March to July, the payroll survey showed employment falling 1.4 million, while nonagricultural employment in the household survey declined only 800,000. Indeed, nonagricultural household employment rose 150,000 in July, while the payroll survey showed employment down 240,000.

The household measure is used in formulating the unemployment rate because it is more comprehensive (it includes the self-employed), but the payroll measure is considered more accurate. For example, the larger decrease in employment through July revealed by the payroll survey is more consistent with the steep decline in industrial production and with the July decline in the wage and salary component of personal income in current dollars. Thus, if the employment decline revealed by the household survey were to match the decline in the payroll survey—which is likely to occur eventually—the unemployment rate could be expected to move at least one-half of a percentage point higher, even without any further growth in the labor force.

There are also strong economic reasons stemming from the interplay of labor supply and demand forces that speak for further increases in unemployment. Economic theory states that higher prices cause a fall in the quantity of a good demanded and an increase in the quantity supplied, all other conditions remaining the same. Applying the theory to the labor market, wages represent the price of labor, with the unemployment rate serving as a measure of the balance between the supply of and demand for labor.

During a period of high or rising unemployment, theory would allow that wages fall. However, in the current era of deeply embedded inflation, *money*, or nominal, wages cannot be expected actually to decline; at best, their growth rate might slow. The key variable is thus *real*, or inflation-adjusted wages. If the actual change in the general price level deviates from previous expectations, then the value of real wages either rises or falls. It is the real wage that guides the decisions of businesses as to how many workers to hire and determines whether potential workers actually seek employment, i.e., the forces of supply and demand. (Other factors, such as the overall level of economic activity, also influence demand for labor, while the supply is also affected by the existence of nonmarket alternatives, such as unemployment insurance.)

In the last period of rising unemployment (from early 1974 to mid-1975), the workers and employers responded to changes in real wages according to economic theory. In the first half of 1974, realized inflation exceeded expected inflation, thus lowering realized real wages. The resulting slower labor force growth, combined with the increase in labor demand, had the effect of holding the unemployment rate steady at about 5%, despite declining economic activity. But in the second half of the year, higher inflationary expectations led to sharply accelerated wage demands. The resulting real wage increases induced more people to seek employment. At the same time, output slumped more sharply as businesses sought to trim inventories, further reducing the demand for the now-more-expensive workers. The unemployment rate then jumped sharply, reaching almost 9% by May 1975.

This pattern has repeated itself in the past eighteen months. In 1979, wage settlements remained steady while inflation accelerated, thus eroding real wages. The unemployment rate fluctuated in a narrow band just below 6%, as supply and demand for labor were roughly balanced. Wages and inflation both accelerated in early 1980 by about the same amount, and the unemployment rate edged up only slightly. But in the spring, wage settlements remained at their new higher level, while inflation abated sharply, bringing about a large increase in real wages. At the same time, output began slumping. The net effect of the reduced demand and increased supply was a sharp rise in unemployment.

General inflationary pressures are continuing to ease (excluding some food price rises attributable to drought-induced supply reductions). And additional cutbacks in production seem likely, as businesses strive to liquidate some of their unwanted inventories. Thus, if wage gains maintain their first-half pace, real wages would increase further, inducing additional increases in unemployment. At the same time, however, the increased slack in the labor market would act to moderate wage demands and lower the real wage, working to pave the way for a self-correcting return to lower unemployment.

Douglas L. Bendt

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars	current monetary conditions	
												latest data	consumer prices	latest data	domestic credit	August 27, 1980			
Argentina	New tax and tariff measures adopted to spur agricultural and industrial output and exports.	Mar.	+ 33%	102.1	$3,825	Apr.	9,034	+ 42%	19.5	0	Foreign loan inflows being encouraged.	July	+100%	Mar.	+ 93%	—	.00050	Interest rates drifting downward.	**Argentina**
Bahamas	Tourist arrivals up 7% in first six months; inflation climbs to rate of 12%.	Mar.	+ 21%	1.1	4,590	June	100	— 6%	2.1	0	Restrictions placed on land purchases by foreigners.	Apr.	+ 12%	Mar.	+ 13%	—	.9800	Higher interest rates slow credit expansion.	**Bahamas**
Bolivia	World Bank approves $50-million loan to assist in economic recovery and structural adjustment.	Mar.	+ 36%	4.7	930	June	144	— 19%	2.1	74	Negotiations to reschedule external debt of $3.4 billion continue.	Apr.	+ 46%	Mar.	+ 51%	—	.0390	Net foreign assets show large declines.	**Bolivia**
Barbados	Economic activity slows from 1979 high, with weaker tourism and sugar harvest delays.	Mar.	+ 22%	0.5	2,000	June	69	— 16%	2.2	4	Import payments up, owing to higher prices.	Mar.	+ 19%	May	+ 25%	—	.5025	Demand for domestic credit increases.	**Barbados**
Brazil	Rate of inflation and wage increase tops 100%, but economic output rate slows.	Mar.	+ 32%	209.1	1,760	Mar.	6,915	— 31%	3.8	0	Reserves drop $3 billion in first half of 1980.	July	+108%	Feb.	+ 79%	33.00%	.0178	Cruzeiro availability limited for nonfarm loans.	**Brazil**
Chile	Consumer prices up an annualized 30% in first seven months of 1980, versus 36% year ago.	Feb.	+ 70%	19.0	1,710	May	2,413	+ 50%	6.4	147	Jan.-Apr. copper exports up 11.5%; international reserves hit $2.4 bn. in May.	July	+ 36%	Dec.	+ 48%	—	.0260	Net foreign assets rising.	**Chile**
Colombia	New Plan of National Integration stresses public investment in communications and transportation.	Jan.	0	28.7	1,100	June	4,086	+ 29%	11.0	0	Rate of devaluation increased.	Apr.	+ 27%	Dec.	+ 11%	30.00%	.0220	Peso availability limited.	**Colombia**
Costa Rica	Record coffee crop anticipated; Government's joint venture with United Brands begins to show results.	Mar.	+ 15%	3.9	1,790	May	87	— 35%	0.7	72	Run on dollar in stock exchange prompts authorities to impose trading limits.	Apr.	+ 19%	Apr.	+ 39%	n.a.	.1172	Domestic liquidity tight.	**Costa Rica**
Dominican Rep.	New austerity program calls for freeze in government salaries and higher gasoline prices.	Mar.	+ 48%	5.3	1,000	June	166	— 24%	1.4	67	Payment for some capital equipment imports transferred to "parallel market."	Feb.	+ 21%	Feb.	+ 14%	—	Par	Credit policy is restrictive.	**Dominican Rep.**
Ecuador	Manufacturing advancing at a 12% annual rate, but agriculture and oil output growing more slowly.	May	+ 46%	8.7	1,070	June	905	+ 49%	5.4	0	Processed exports up sharply.	Apr.	+ 13%	Feb.	+ 43%	8.00%	.0370	Bank liquidity increasing.	**Ecuador**
El Salvador	Junta approves $50-million investment plan to reverse economic decline and check capital flight.	Dec.	+ 2%	3.4	760	June	78	— 73%	0.9	0	Coffee crop may drop by 25%, owing to poor weather and coffee rust.	June '79	+ 9%	May	+ 56%	—	.4015	Liquidity is tight.	**El Salvador**
Honduras	Government stepping up efforts to entice more companies for petroleum exploration.	Nov.	— 10%	1.9	540	Apr.	252	+ 21%	3.7	21	Higher prices for most principal exports should spur export growth.	Nov.	+ 14%	Apr.	+ 6%	4.00%	.4980	Rediscount lines increased by $12.5 million.	**Honduras**
Mexico	Inflationary pressures mount; major labor union seeks 30% annual wage increase.	Mar.	+ 79%	117.9	1,700	Mar.	2,223	+ 10%	2.1	87	Severe drought necessitates increased food imports.	May	+ 25%	Dec.	+ 31%	—	.0400	Peso credit availability is limited.	**Mexico**
Panama	Expansion of Colon Free Zone under way, along with port and rail improvements.	Mar.	— 25%	2.7	1,420	June	193	— 4%	2.3	33	Crop losses cause drop in banana exports.	Mar.	+ 15%	Mar.	+ 21%	—	Par	Credit availability is generally satisfactory.	**Panama**
Paraguay	Inflation declines to 6.9% rate of increase in first six months; economic activity buoyant.	Feb.	+ 2%	3.7	1,225	June	685	+ 26%	15.0	0	Cotton and soybean price declines trim export earnings.	Apr.	+ 34%	Feb.	+ 24%	—	.007930	Monetary policy is restrictive.	**Paraguay**
Peru	Economy grew 3.2% in IQ, vs. 4.1% for all 1979; civilian president after 12 years military rule.	Mar.	+ 55%	12.1	700	Apr.	1,760	+362%	9.9	537	Trade balance posted a $763-mn. surplus in first quarter, double year ago.	Mar.	+ 60%	Dec.	+ 16%	29.50%	.0035	Net international reserves continue rising.	**Peru**
Uruguay	Real GDP grew 8.4% in 1979, up from 3.9% in 1978, mainly because of a tourist and construction boom.	Feb.	+ 15%	7.2	2,500	Apr.	457	— 18%	6.7	0	Tariffs to be reduced annually by 16%.	July	+ 71%	Mar.	+ 94%	—	.1105	Credit growth is rapid.	**Uruguay**
Venezuela	Country remains in recession; SIEX reorganized in effort to attract foreign investment.	Mar.	+ 50%	46.1	3,385	June	6,664	+ 29%	7.2	0	A $1.8-bn. loan obtained, some of which will help restructure short-term debt.	May	+ 24%	Mar.	+ 3%	12.00%	.2300	Interest rate ceiling lowered further.	**Venezuela**

World Interest Rates

market rates of August 27, 1980; bond yields as of August 22, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	10.45	16.00	12.00	9.50	7.50	15.00* penalty rate 18.00	9.00	3.00*	8.25
Day-to-Day Money	10.25 Aug. 28	10.50	16.00	11.00	11.0625	9.50	16.875*	10.125	5.00*	11.6875
Treasury Bills 91-day, Middle Rates	10.04	10.45	14.34	12.35	11.53 one-year	n. a.	15.35* 160-day	no dealing	no market	6.75
Commercial Paper prime, 3-month, asked	10.00 finance paper	10.60 finance paper 15% tax w/h	14.53	11.90 Certified	11.4375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.50	10.50 15% tax w/h	15.75	11.90 Certified	not traded	9.90	20.00*	no market	4.50*	no market
Government Bonds Long-term, new and old issues, average yield	11.13	12.80	13.37	10.86 20% tax w/h	12.58	7.74*	15.58*	9.73	4.58*	8.45
Industrial Bonds prime, long-term, new and old issues, average yield	12.20 Aa Industrials	13.375	13.85	14.34	13.83	7.82*	15.70*	10.25	5.615*	7.31
Bank Short-Term Rate to Best Borrowers (prime rate)	11.50	12.50	17.50	15.75	13.85	11.50	19.625*	12.00	5.75*	8.50
Bank Time Deposits 3-month	10.125 Cert. of Dep.	10.25 Cert. of Dep.	16.50	12.35	11.4375	8.75	10.75*	10.875 large deposits	5.50* residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	12.00	no market	17.25	no market	12.375	8.8125	no market	10.875	6.3125*	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8558	2.3945	.0346	.2386	.5555	.001169	.5092	.6024	.004561
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.00 *P*	4.875 *D*	.75 *D*	.75 *D*	3.00 *P*	20.5 *D*	1.00 *P*	5.25 *P*	.25 *D*

Eurodollar Deposits
(London, interbank, bid)
Aug. 28

7-day	**8.9375**
1-month	**10.125**
3-month	**11.6875**
6-month	**12.125**

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ **.75**
U.S.-Canada Treasury Bills	− **1.01**
U.S.-Canada Finance Co. Paper	− **1.45**
Eurodollars-U.K. Local Auth. Deposits	− **.06**

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**11.875**
Over 7 yrs.	**12.25**
DM Bonds	
7 yrs. and under	**7.78**
Over 7 yrs.	**7.78**

Gold Price
London
afternoon fixing
633.85
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Rates as of Aug. 20, 1980; bond yields as of Aug. 15.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	13.2 (July)	10.1 (July)	16.9 (July)	13.5 (June)	5.5 (July)	21.6 (July)	3.3 (July)	8.4 (June)
Industrial production*	−9.2 (July)	−2.0 (June)	−6.7 (June)	0 (June)	−1.6 (June)	9.4 (June)	9.3 (Mar.)	5.8 (June)
Trade balance† *(billions of local currency units)*	−$2.28 (June)	C$0.89 (June)	£0.26 (July)	−FF5.39 (July)	DM0.28 (June)	−Lit.1,010 (June)	−SF0.99 (July)	¥28.3 (June)
Money supply (M_1)*	3.2 (July)	1.4 (June)	2.8 (May)	8.2 (Apr.)	1.6 (May)	20.6 (Mar.)	−11.7 (May)	1.9 (May)
Velocity of money* (M_1)*	2.7 (Mar.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	−0.2 (Sept.)	n. a.	3.8 (Dec.)
Reserves minus gold *($ million, change from previous month)*	130 (June)	83 (June)	188 (June)	85 (June)	1,366 (June)	−1,768 (June)	2,436 (June)	1,292 (June)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

Fashioning a U.S. Export Policy

The clarion call for a revitalized U.S. export policy appears now to have been muffled as the country's politicians pursue larger goals. Electioneering, the debate over tax cuts, and the broader issue of supply-side stimuli have taken center stage, pushing the export policy launched in September 1978 by the Carter Administration to the sidelines.

Several factors may be contributing to the Administration's apparent unwillingness to put teeth into export policy. First, there is a strong belief that if U.S. domestic economic problems are tackled within the context of a broader "reindustrialization" policy, exports and the balance of payments would strengthen as a consequence. And second, the U.S. balance of payments itself has improved. Although trade deficits have persisted (a trade shortfall of about $31 billion is forecast for 1980, up slightly from the $29.5-billion gap of 1979), the current account, which includes trade and services, has performed better After recording a current-account deficit of $10 billion, annualized, in the first quarter, the United States may have achieved a balance in the second quarter and may post a small surplus for 1980 as a whole. While some of the factors responsible for the improvement are cyclical—such as the weakened domestic economy and the resultant drop in import demand, especially for oil—others, specifically, rising services earnings, are likely to be more permanent. Nonetheless, there is concern that, depending upon economic conditions in Europe, the balance of payments could deteriorate sharply once the U.S. economic recovery gets under way.

The United States may well experience continued trade deficits and possibly large current-account shortfalls in the 1980s, despite the expectation of annual increases in export volume and services earnings. The reasons include the anticipation of extremely slow advances in productivity, continued high inflation, and unrelenting increases in oil import costs. These problems are compounded by the erosion of U.S. competitiveness stemming from its loss of a technological edge, the promotion and subsidization of exports by a growing number of advanced and developing countries, and the dollar's diminishing reserve role.

Thus, while it is vital to encourage the current interest in reindustrializing through productivity-enhancing tax cuts, stepped-up research and development, inflation control, and the reduction in energy dependence, there is also strong justification for a complementary export policy.

The most critical challenge in any policy of export promotion is the dismantling of the obstacles and bureaucratic impediments to exports. Such barriers have accumulated over years during which U.S. trade policy was neglected or subjugated to non-trade-related ends. The obstacles to U.S. exports run the gamut. They include:

- *Taxation of income earned by Americans working abroad.* The United States is the only industrialized nation to tax on the basis of citizenship rather than country of residence.
- *The Foreign Corrupt Practices Act.* This law, which bans bribery to obtain business contracts, discourages U.S. firms unsure of what conduct is illegal and how the law will be interpreted.
- *Webb-Pomerene Export Trade Act of 1918.* This law's ambiguous anti-trust provisions applicable to export trade associations have discouraged the formation of trading firms and associations.
- *Numerous restrictions on exports* stemming from national security, human rights, nuclear non-proliferation, and environmental impact concerns.

The export policy put forward by the Carter Administration in the fall of 1978 represented a limited acknowledgement of the need to boost the priority of exports. The program gave minimal attention to eliminating existing barriers or to creating significant new incentives, focusing instead on reorganizing government trade functions. It consolidated the Government's scattered trade responsibility in two key trade agencies: the U.S. Department of Commerce and the U.S. Trade Representative (USTR).

In addition to the reorganization, the Carter program called for:

- boosting Export-Import Bank direct lending and guarantee authority for fiscal 1980 to $5.1 billion;
- allocation by the Small Business Administration of $100 million of existing funds annually for export loan guarantees;
- $20 million for export development programs of the Departments of State and Commerce;
- an effort to assess the "export consequences" of restrictions on exports to Communist countries;
- a commitment to work with Congress to devise better tax incentives for exports and lighten the tax burden on Americans working overseas;
- an easing of the requirement for environmental impact statements; and
- a call for the Justice Department to provide more expedient guidance on anti-trust matters.

In terms of new expenditures, the President's new policy provided little. But more important, it has been criticized for not making a serious effort to remove the obstacles to exports and provide new incentives.

As for the reorganization itself, it has been faulted for dividing authority between Commerce and the USTR by placing the USTR in charge of policy and

Fashioning a U.S. Export Policy

(continued from page 7)

Commerce in charge of operations. Such a mechanism, argue critics, deprives the export cause of the strong, centralized leadership it needs. Proponents contend, however, that it more accurately reflects the pluralistic interest in trade that prevails within government and the political realities of bureaucratic consolidation.

With respect to the specific measures Mr. Carter called for in 1978, the results to date are mixed. Although Congress has recently approved raising the Export-Import Bank's combined loan and guarantee authority to $5.1 billion for fiscal 1980 (which will end in just four weeks), little has been done to remove the wide range of restrictions on exports.

Supporters of the reorganization contend that it is still far too soon to pass judgment on the plan. A senior Commerce official insists that more has been accomplished than is realized but that substantial results will not show before 1981. He cautions, however, that the numerous impediments to exporting have strong constituencies and will be difficult to eliminate. At best, he feels, the old barriers will only be weakened somewhat, while the real emphasis will have to be on the creation of new incentives—an approach that would very likely compound the bureaucratic confusion for would-be exporters.

The Administration's next step will be to report to Congress on the wide range of incentives and disincentives for U.S. exports. The report—the release of which is imminent—will follow up a February 1980 statement on disincentives that skirted the most thorny issues and lacked specific proposals to boost exports. This time, the President is likely to announce more concrete action with respect to: easing the income tax burden on American workers overseas; clarification of uncertainties in the Foreign Corrupt Practices law; assuring the Export-Import Bank adequate and timely financing authority in the future; and modifying export licensing requirements.

Such efforts still fall short of the strong measures needed, but they do indicate the Administration's interest in sustaining the momentum. Interestingly enough, the strong support for export initiatives is coming from Congress—the body largely responsible for putting in place the existing export barriers.

There are currently a number of trade-related bills under consideration in Congress. Perhaps the most widely touted is Senator Adlai Stevenson's bill to promote the creation of export trading companies. By diversifying trade risks and developing economies of scale in marketing, financing, and related trade services, these intermediaries could have a significant impact by involving small and medium-sized firms in exporting. The bill also provides for a mechanism of certification and clearance from the anti-trust provisions of Webb-Pomerene. Another bill seeks to clarify uncertainties in the Foreign Corrupt Practices Act, while the Senate Export Caucus' National Export Policy Act of 1980 would make the export expansion issue a national priority through wholesale revisions of existing laws and coordinated government programs and policies.

The need for a strong U.S. export policy now appears to be a well accepted notion in the United States. And this time the interest may endure. The rash of Congressional initiatives indicates a growing grass-roots support of export promotion. This raises the possibility of a greater integration of export policy into the economic and political decision-making process in Washington in the future. Moreover, the interest in exports has now been further institutionalized, with the reorganization having put in place what may prove to be a more effective mechanism for melding trade interests and eliciting presidential approval.

A key problem is getting the U.S. political and legislative system to respond to new initiatives in light of the overlapping jurisdictions both within Congress and still within the Administration. If the differing vested interests can be gradually overcome, and a consensus forged on new export incentives, legislation can be pushed through—or more importantly, old barriers removed.

Achieving a consensus within Congress and the Administration is only half the battle, however. Commitment to boosting exports must also show itself in the private sector. While there are signs that segments of the banking community are responding to the need for greater trade finance expertise, reorienting U.S. manufacturers to the international marketplace is perhaps the most formidable obstacle. American manufacturers must begin assessing the international competitiveness of their products and approach foreign marketing with greater sophistication by researching cultural and business patterns of foreign markets and through product adaptation. And they must be given the incentives to make the longer-term investments to permit profitable export operations in the future.

Another important challenge is the enlistment of the cooperation of labor in the export effort. The vital task in this regard is to focus labor's efforts on enhancing productivity and product quality and competitiveness. At the same time, U.S. officials must also act to neutralize *foreign*-imposed barriers to U.S. exports—including non-tariff barriers and other policies that have the effect of limiting access of U.S. goods to markets abroad—by effectively enforcing the new Tokyo Round codes. Only when serious action is taken on all these fronts will U.S. exports be competitive and have a fighting chance in world markets.

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CHASE

International Finance

Vol. XV, No. 18
September 15, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

9/15/80

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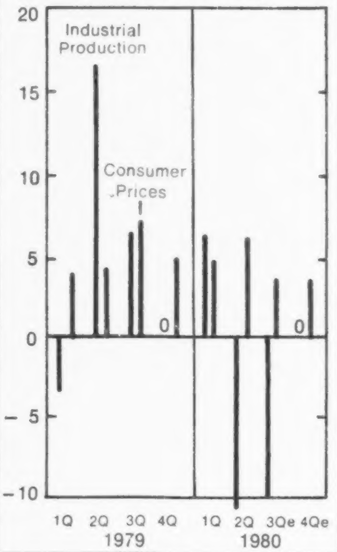
German Monetary Policy Guided by Concern for Mark

The economic recession in Germany is now all but confirmed. Industrial production peaked in March, subsequently declining at an annual rate of 10% in the second quarter. At the same time, the volume of total industrial orders plunged at an annual rate of 20%, with domestic orders falling even more precipitously. Building permits, retail sales, and imports have also shown real declines, and unemployment has risen. German inflation has responded to the economic downturn. Prices in the past two months have risen at monthly rates of 0.2% and 0.1%, respectively, down from monthly rates of about 0.5% in the second quarter. The latest year-over-year inflation rate is 5.5%.

In the past, economic slowdowns of this sort, accompanied by a falling rate of inflation, have led the German Bundesbank to reduce its key discount and Lombard interest rates. Yet so far, these rates have remained at their record levels (both absolutely and relative to inflation). Moreover, the growth of the broad money stock remains at the bottom of the 5%-8% 1980 target range, and the narrow money supply continues to show no growth at all.

Key German economic indicators
(quarterly % change, annual rate)



What distinguishes monetary policy in the current business cycle from previous policy responses to similar circumstances is the German external-account position. A current-account deficit of 12.7 billion marks was registered in the first half of the year, and a shortfall of approximately 25 billion marks is expected for the year as a whole. This is putting incipient pressure on the mark. But Bundesbank policy is implicitly targeted at maintaining a stable-to-strong mark, both to sustain confidence in a currency increasingly held as an international reserve asset and to stabilize prices. This explains the $6 billion spent defending the DM in the first quarter and the subsequent rise in interest rates to finance the current-account deficit through private capital inflows.

Germany's current downturn is expected to worsen as the world slowdown affects exports, but inflation will continue to ease. Domestic objectives will then be given increasing weight by policymakers. Furthermore, a low inflation rate and the prospect of an improved current-account balance toward yearend should impart greater strength to the DM on foreign-exchange markets. Consequently, German interest rates are expected to decline. This time, however, the extent of the decline will be more than usually determined by developments in Eurodollar and other foreign interest rates.

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Swiss central bank removes obstacles to capital inflows.

The Swiss National Bank recently announced measures that acknowledge the franc's growing role in the international monetary system. Foreign banks are now able to participate in Swiss franc private placements and to take part in franc credits granted by Swiss banks to foreigners—moves which should improve the monitoring of international Swiss franc lending. In addition, interest will now be payable on all foreign-held franc bank accounts. This action marks the final step in removing barriers to capital inflows first imposed in the mid-1970s. It is also aimed at bolstering the franc on foreign exchange markets, since a firm franc remains a key element of Swiss economic policy. The central bank remains concerned about the impact of a buoyant domestic economy on inflation and the balance of payments. A current-account deficit is likely to be recorded this year for the first time since 1965. Consequently, no early relaxation of monetary policy is likely. Indeed, the central bank is expected to lag any moves by the German Bundesbank toward a less restrictive monetary stance.

Denmark adopts tough measures to boost current account, but more is needed.

The Danish economy is now faced with serious problems stemming from its repeated failure to adjust to higher oil prices. Since 1974 export earnings have not risen sufficiently, nor have non-oil imports decreased enough to prevent a huge balance-of-payments deficit. In addition, high inflation and membership in the European Monetary System (EMS) have helped produce an overvalued currency that has further widened the country's current-account gap. The price extracted by the deficit has been mounting international indebtedness. New borrowing necessitated by this year's deficit—estimated at 19 billion kroner (over 5% of GDP)—will boost such indebtedness to about kr. 100 billion (some 28% of GDP) by yearend. Interest payments on the additional debt will absorb 3% of export recepits, further precluding the achievement of current-account equilibrium. To check the widening deficit, the Danish Government is curtailing economic growth by allowing consumers' real incomes to fall and by squeezing investment. GDP is thus expected to decline by 0.5%-1.0% over the course of 1980. This will at best only stabilize the current-account deficit, as much more will be needed to reduce it. At the same time, the continuing high inflation makes the kroner a good candidate for devaluation within the EMS.

Sweden likely to continue dampening domestic demand to ease current-account deficit.

Economic slackening in the United States and Europe is alarming Swedish authorities concerned about the implications for Swedish exports. A 1980 current-account deficit of at least 17 billion kroner is already anticipated, and further deterioration in export earnings would compound the problem. The coalition government, with a parliamentary majority of one, has limited room to maneuver, yet it has managed to raise sales taxes (VAT) to just over 23% on about 60% of all goods and services consumed in Sweden. And in October, the authorities will submit a plan to cut public expenditures by seven billion kroner. Most observers agree, however, that such measures will be inadequate to forestall a further widening in the balance-of-payments deficit, particularly with the May wage settlements adding 11%-12% to incomes. Foreign borrowing of perhaps as much as 20 billion kroner may prove necessary to finance the deficit. Such a level, however, would double the state's foreign debt level from its kr. 20-billion level at the start of the year. A debt of 40 billion kroner, equivalent to about 6% of GDP, is uncomfortably high for neutral Sweden. Accordingly, the authorities are likely to depress domestic demand still further, even if such steps necessitate calling another election during the winter.

Japanese economic slowdown dampening inflation and improving balance of payments.

Confirmation is now in that Japanese economic growth has begun to slow. Nearly all the first-quarter GDP growth was export-related, with domestic demand remaining flat. Economic growth in the second quarter is also likely to have been minimal, based on the small (0.3%) rise in industrial production. The growth slowdown, however, has eased inflationary pressures. Wholesale prices have moderated since May, with the year-over-year inflation rate down from a peak of 24% in April to 18.5% in July, and the trend continues downward. The domestic economic slowdown is expected to continue through the year, largely the result of steady declines in consumer demand stemming from the erosion in consumers' real incomes. Consumer prices are estimated to rise by an average of about 8% for the year. The current account—in deficit by more than $10 billion for the first six months of 1980—should also see rapid improvement this year as export growth is maintained while imports are curtailed by domestic recession. The expectation is thus for a strengthening of the yen on foreign-exchange markets and a gradual decline in interest rates as the year progresses.

Philippine authorities must reconcile conflicting interests in fight against inflation.

Efforts to curb inflation are creating difficulties for the Philippine Government. Domestic oil product prices were boosted in August, triggering demands for increases in other energy-related products and services and adding to the mounting pressure for wage increases. At the same time, the oil price rises were insufficient to compensate oil companies for the rise in crude prices. This has led to an oil company profit squeeze with potentially serious implications for the economy. On the wage front, Philippine President Marcos responded to labor pressures by raising the minimum wage 13% in August. The trade unions, however, were unsatisfied, while employers argued that such an increase would jeopardize export-oriented industry. Price indexes through May indicate an annual rate of inflation of between 15% and 20%. And the Government's oil price and minimum wage actions are expected to sustain this same high pace of inflation through the second half of 1980.

Argentina achieves reduction in inflation, but industrial problems are a concern.

Argentina has met with a fair amount of success in controlling inflation over the past few months. In August, the annual rate of consumer price increase dropped to 86%, versus 171% in August 1979. The improvement is partly the result of a policy of lagging the monthly exchange-rate devaluation behind the inflation rate, resulting in a real appreciation of the Argentine peso. In addition, a policy of promoting competition with imports is helping bring down prices. This program, however, has led to a sharp rise in imports and a merchandise trade deficit of $500 million in the first half of 1980, compared with a surplus of $1.4 billion for January-June 1979. The import surge has been difficult for import-competing Argentine industries, while the lagging devaluation has hurt exporters. As a result, many firms' profit margins have been squeezed, and labor cuts have occurred. The Government is expected to persist with its program of lagging devaluation, but pressure is building within the business community for a change in course. Despite the trade deficit, international reserves rose to more than $10 billion in August as minimum term restrictions on foreign funds were lifted, partly to assist local firms in meeting liquidity needs.

Iranian economic prospects bleak; hopes hinge on oil export recovery.

The Iranian economy has deteriorated further in recent months. In April, 12 Japanese firms, together with Shell Oil and British Petroleum, ceased purchasing their contracted 850,000 barrels per day of Iranian oil, and pressures from their respective governments have kept them from reversing their decisions. Iran has been unable to locate new markets for its oil, and exports have been cut to approximately one million barrels per day, versus 1.75 million bpd in the first quarter and 2.5 million bpd in the second half of 1979. If exports do not recover —a strong possibility given the present world oversupply—revenue for 1980 will probably total only $13 billion, some $2 billion less than current requirements. The revenue loss will have serious repercussions for the domestic economy, as oil revenues are critical to the health of public finances. Export earnings of $24 billion were originally projected for 1980, and some budget cuts have been necessary. Nonetheless, a large budget deficit is still likely, which will further fuel an inflation rate now estimated at 50%. In the meantime, unemployment is extremely high and economic activity depressed, with few signs of improvement in the offing.

BEST AVA

Retail Trade Shows Unexpected Strength

Retail sales data released last week revealed far more rapid advances than many observers had expected. According to the report, retail sales rose 1.5% in August, well above the small gain that was a general consensus forecast. In addition, July retail sales figures were revised significantly from the 2% increase initially reported to a 3.1% rise.

The overall conclusions to be drawn from the July-August figures are unusually uncertain because of the complexities of price changes. At the moment, however, the stepped up retail sales growth appears primarily to reflect price advances. For example, retail food prices have begun to accelerate sharply. And the 2.8% rise in the dollar amount of retail auto sales—a major contributor to August's total retail trade figure—was accompanied by a modest decline in unit sales. To be sure, some actual sales strength was reflected in other durables, in part related to unusually hot weather and also to the somewhat faster pace of new housing starts.

Overall consumer credit in July was also reported last week. According to the figures, new extensions of credit during the month rose almost $4 billion, to a volume of $24.5 billion—a jump of over 18%. Liquidations were $25.1 billion, resulting in a net decline of credit outstanding of $600 million—the smallest since the drop in credit began in April. The largest contributor to the rise in extensions was auto credit, but most other forms—such as retail credit and credit cards—also showed solid increases. These and other signs suggest a recovery from the constricted credit conditions that accompanied the credit restraint program announced in March.

Although overall credit data for August will not be available for another month, evidence from limited bank data suggests credit expansion since July has remained moderate. Loans to individuals by large banks in August were essentially unchanged from their end-of-July levels. And while the relationship between that series and overall consumer credit is not known with predictive precision, indications are that total credit in August probably rose only slightly, on balance.

In sum, the new retail sales data (including the revisions) suggest slightly stronger "real" spending activity and a pronounced contribution to sales by inflation. As such, they are clearly a source of concern to financial markets. Interest rates have been rising since June, reflecting continuing inflation pressures, some strengthening of economic activity overall, and rapid money growth. There have been widespread expectations, to be sure, of an eventual reversal of the interest rate advance. But the latest retail trade figures are a new source of uncertainty for such an outlook.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALAN				
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	li
Africa	**Algeria**	Oil exploration surcharge of $3 per barrel to be suspended on September 1.	June	+ 59%	24.6	$ 1,374	July	3,482	+ 75%	5.4	
	Botswana	Improvement of investment incentives for labor-intensive industries under consideration.	Mar.	+ 38%	0.4	550	July	340	+ 42%	7.1	
	Egypt	Government considering establishment of holding companies to manage public-sector firms.	Mar.	+ 63%	16.4*	400	June	1,005	+228%	3.3	
	Ethiopia	Military spending saps economy; real economic growth just 2% in 1979.	Mar.	+ 43%	3.1*	105	July	140	+ 20%	2.8	
	Gabon	Last year saw return to positive real economic growth, estimated at 5.7%.	Dec.	+ 47%	3.6*	6,550	Apr.	37	− 59%	1.2	
	Ghana	Industrial utilization rate below 30% attests to continuing economic crisis.	n.a.	—	4.3	385	May	376	+ 40%	4.5	
	Kenya	Slower real economic growth brings decline in per capita purchasing power.	Feb.	+ 43%	6.0*	400	May	534	+ 24%	3.5	
	Madagascar	Real economic growth spurted 10.3% in 1979, while inflation rate accelerated to 14%.	Dec.	+ 7%	2.1	252	May	9	− 72%	0.1	
	Morocco	Several new hotels under construction to enhance revenue from tourism.	Mar.	+ 52%	12.8	678	June	258	− 59%	0.8	
	Niger	Lower uranium prices may bring downward revision of five-year development plan targets.	Dec. '78	+ 51%	1.1	220	May	129	+ 14%	n.a.	
	Nigeria	A 25% jump in federal spending should boost economic activity in second half.	May	+ 71%	50.7*	627	June	8,277	+186%	8.0	
	South Africa	Real economic growth of 7% expected in 1980.	May	+ 40%	57.3*	2,070	May	846	+ 11%	0.9	
	Tunisia	Planned $1-billion investment program aims to double phosphate output by 1990.	Dec.	+ 52%	5.9	966	July	672	+ 83%	3.2	
Middle East	**Iraq**	A $1-billion contract to establish an electronics industry awarded to a French company.	June	+ 77%	23.3	1,875	n.a.	—	—	—	
	Jordan	Fifteen sectoral committees set up to identify projects for 1981-85 development plan.	Dec.	+ 29%	2.8*	917	July	1,120	+ 12%	7.5	
	Kuwait	Government outlays projected to rise 30% in 1980/81, to $10.95 billion.	June	+ 1%	23.3	18,330	July	3,160†	+ 15%	8.4	
	Saudi Arabia	Economy's real growth rate reportedly 9% in 1979/80, up from 7.5% year earlier.	June	+ 94%	54.5**	8,400	May	22,437†	+ 34%	11.6	
	United Arab Emirates	Private-sector economic activity on upswing.	Mar.	+ 85%	13.8	19,435	July	1,999†	+121%	3.7	

*1979 **FY 1977/78 †Excluding state r

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Rapid Auto Recovery Unlikely

The American automobile industry is anxiously hoping the worst of its troubles are over. After suffering one of their most trying years in history, auto producers are nervously awaiting consumer response to new products intended to bring the industry out of its current depression and back on the road to regaining lost market shares.

Auto industry statistics did show some improvement over the summer months, and in fact, may have contributed disproportionately to boosting aggregate indicators of national economic health. For example, about one-third of the huge 8.4% increase in new orders for durable goods in July—the first positive change in that figure since January—was attributable to shipments in the motor vehicle industry. In addition, the hefty increases in June and July retail sales were considerably more moderate when discounted for price-promotion-prompted auto sales. And further, the biggest positive factor in July's record increase in the Government's composite index of leading indicators—the improvement in the layoff rate—was strongly influenced by fewer new layoffs in the auto industry.

The strength from the auto sector is likely to prove somewhat illusory, however. For one thing, summer is the season for statistical distortions in the industry as assembly plants close down for new model retooling. The timing and duration of this annual ritual are so erratic from year to year that significant revisions in the seasonal adjustment of indicators such as durable goods orders are often necessary.

But more important, any further boost to the economy from autos will be determined by the robustness of sales in the new model year. August sales were not as encouraging as the June-July figures. And at this point, the combination of sustained high inflation and a generally sluggish recovery in other sectors of the economy, coupled with such industry-specific forces as higher new car prices, Americans' recent appetite for imported autos, and the still-limited capacity of producers to turn out the small cars in greatest demand, seem likely to keep sales relatively weak through yearend. Moreover, with interest rates still high, manufacturers want to avoid even a temporary buildup of dealer inventories. As a result of all these influences, the major U.S. producers have set tentative output plans through yearend well below assemblies during the 1974-75 recession and at the lowest level in nearly a decade.

The U.S. Labor Department reported the unemployment rate for the auto industry in August at 21%. This was down significantly from the 29% industry peak in May—and undoubtedly contributed to the surprising drop in the national unemployment rate just at a time when economists expected the labor markets to show further weakening. And while additional reductions in the number of furloughed auto workers are expected, they will be limited unless new auto sales prove to be stronger than expected.

E OF PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				September 10, 1980			
e of IMF edit, mil- s of dollars	current influences on paymen.	latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars	current monetary conditions	
0	LNG exports to France regaining normal levels.	June '79	+ 14%	Dec.	+ 15%	—	.2620	Credit generally available.	**Algeria**
—	Diamond output, a source of half export earnings, headed much nigher.	Apr.	+ 12%	Apr.	−205%	5.75%	1.3100	Net foreign assets rise sharply.	**Botswana**
277	Suez Canal tolls to be raised November 1.	Mar.	+ 20%	May	+ 16%	10.00%	1.4100	Money supply sustains steady expansion.	**Egypt**
48.2	Oil bill for 1980 equal to about 60% of gross foreign-exchange earnings.	Apr.	+ 11%	Mar.	+ 27%	—	.4840	Money supply level since mid-1979.	**Ethiopia**
20.1	Net 1980 oil receipts forecast to rise 25%, despite 8% lower output.	Dec.	+ 10%	Apr.	+ 25%	—	.6000	Net foreign assets turn positive in March quarter.	**Gabon**
68.8	Cocoa receipts in 1980 may fall to $500 mn.; oil bill of $325 mn. foreseen.	Apr.	+ 18%	Mar.	+ 18%	13.50%	.3600	Money supply continues to decline.	**Ghana**
138.8	Relaxed import controls will widen current-account gap to over $600 mn.	Apr.	+ 15%	Apr.	+ 14%	—	.1400	Selective credit restraint continues.	**Kenya**
12	Despite higher export receipts, 1980 current-account gap could widen.	Apr.	+ 17%	Sept.'79	+ 48%	—	.2430	Budget deficit likely to sustain credit growth.	**Madagascar**
194	Despite higher phosphate prices, first-quarter trade gap larger than in '79.	June	+ 10%	May	+ 11%	n.a.	.2630	Euroloan of $250 million signed August 26.	**Morocco**
—	Fruit and vegetable exports fall.	May	+ 11%	May	+ 39%	10.50%	.0048	Credit to private sector expands briskly.	**Niger**
—	Measures adopted to woo foreign investment in agriculture and housing.	Sept.'79	+ 11%	Dec.	+ 2%	5.00%	1.900	Record net foreign assets expand money supply.	**Nigeria**
—	A $250-million Eurocredit obtained.	June	+ 15%	Apr.	+ 18%	7.00%	1.320	Cut in money supply expected.	**South Africa**
32	Crude petroleum revenue rising steadily.	May	+ 10%	Apr.	+ 6%	5.75%	2.520	Joint investment bank to be set up with Kuwait.	**Tunisia**
0	Oil output averaged 3.5 million bpd in first half, up 6.6% from year earlier.	Sept.'79	+ 8%	n.a.	—	—	3.390	Credit generally available.	**Iraq**
0	First-quarter phosphate export value up 57% from like 1979 period.	Apr.	+ 14%	May	+ 24%	6.00%	3.420	Money supply rising.	**Jordan**
0	Budget projects oil revenue of $16.8 bn. in 1980/81, up 44% from 1979/80.	Dec.	+ 6%	May	+ 30%‡	—	3.730	Ban lifted on trading non-Kuwait Gulf firms on stock exchange.	**Kuwait**
0	Government expected to cut oil output and boost prices in fourth quarter.	Mar.	+ 2%	Feb.	+ 84%‡	—	.2980	Claims on private sector growing rapidly.	**Saudi Arabia**
0	Abu Dhabi trade surplus $8.67 billion in 1979, up 54% from 1978.	n.a.	—	May	+ 3%	—	.2680	Legislation to set up central bank approved.	**United Arab Emirates**

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‡Private sector only

World Interest Rates

market rates of Sept. 10, 1980; bond yields as of Sept. 5, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	10.57	16.00	12.00	9.50	7.50	15.00 penalty rate 18.00	9.00	3.00*	8.25
Day-to-Day Money	10.25 Sept. 11	10.25	16.00	11.15	11.25	9.50	16.875	10.375	5.00*	11.4375
Treasury Bills 91-day, Middle Rates	9.98	10.40	14.50	12.35	12.02 one-year	n. a.	14.849 80-day	no dealing	no market	6.75 2-month
Commercial Paper * prime, 3-month, asked	10.25 finance paper	10.60 finance paper 15% tax w/h	13.8859	11.60 Certified	11.875* Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.55	10.55 15% tax w/h	14.875	11.60 Certified	not traded	9.90	20.20	no market	4.50*	no market
Government Bonds Long-term, new and old issues, average yield	11.04	12.90	13.25	10.821 20% tax w/h	12.68	7.99	15.64	10.06	4.91*	8.501
Industrial Bonds prime, long-term, new and old issues, average yield	12.35 Aa Industrials	13.50	14.03	14.977	12.88	8.16	15.90	10.57	5.625*	7.33
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	12.25	17.00	15.75	13.85	11.50	19.625	12.00	5.50*	8.50
Bank Time Deposits 3-month	10.50 Cert. of Dep.	10.35 Cert. of Dep.	15.625	12.30	11.8125	8.75	10.75	10.625 large deposits	5.75* residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	11.6875	no market	16.125	no market	12.25	8.625	no market	10.625	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8596	2.404	.03509	.2421	.5622	.001182	.5168	.6135	.004619
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *P*	4.00 *D*	.75 *D*	.375 *D*	3.00 *P*	12.25 *D*	.75 *P*	6.00 *P*	1.00 *D*

Eurodollar Deposits

(London, interbank, bid)
Sept. 11

7-day	10.125
1-month	10.75
3-month	11.50
6-month	11.6875

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .32
U.S.-Canada Treasury Bills	−1.03
U.S.-Canada Finance Co. Paper	−1.20
Eurodollars-U.K. Local Auth. Deposits	0.0

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.50
Over 7 yrs.	12.25
DM Bonds	
7 yrs. and under	7.45
Over 7 yrs.	7.45

Gold Price

London afternoon fixing

686.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Sept. 3; bond yields as of Aug. 29.

The Soviet Economy: Main Indicators to 1982

(percent change)

	Actual						Projected		
	Average 1971-75	1975	1976	1977	1978	1979	1980	1981	1982
Gross National Product[1]	4.0	2.0	4.1	3.6	4.1	1.1	3.4	3.0	3.0
Industrial production[1]	5.9	5.6	3.7	4.1	3.3	2.3	3.4	3.5	3.4
Agricultural output[1]	2.1[2]	−8.3	7.6	3.4	4.7	−3.7	3.6	1.2	1.9
New capital investment	7.0	8.7	4.5	3.7	5.7	2.0	3.7	3.6	3.9
Real consumption (public and private)	3.9	4.8	2.8	3.3	2.6	2.0	2.7	2.4	2.3
General price level	1.8	1.7	1.9	1.0	1.7	1.7	2.0	2.0	2.0

Source: Projection of SOVMOD V, August 1980.

Notes: [1] Rates of growth using Western estimates of output, national product, etc. tend to be somewhat lower than Soviet official estimates because of differences in classification and weighting.

[2] Annual growth of five-year moving averages for 1970 and 1975.

USSR Looks for Moderate Recovery in 1980

The Soviet economy performed poorly in 1979. National income rose only 2%, with industrial production up 3.4% and agricultural output down 4%. The total volume of investment grew only 1%. The contributing factors included a poor grain harvest, a severe winter that cut energy production while boosting demand, and critical bottlenecks in freight transportation.

The major bright spot was foreign trade. The trade gap with the West narrowed to $1.1 billion from $3.3 billion in 1978; exports soared by 45%, mainly the result of higher oil prices and increased sales of natural gas to Western Europe. The Soviet Union's traditional trade surplus with developing countries widened to $4.7 billion.

The Soviet annual plan for 1980 projects a recovery from the economic malaise of 1979. National income is targeted to rise 4%, based on a 4.5% jump in industrial output and an 8.8% rise in agricultural production.

The Soviet economy should indeed rebound in 1980. This expectation is based on four major influences on Soviet economic performance this year: increased domestic capital spending as the five-year plan draws to a close; the economic slowdown in the West; the anticipated recovery from harsh winter conditions and a dismal agricultural showing in 1979; and the impact of Western actions taken in the wake of the invasion of Afghanistan. The Soviet economy is estimated to register national income growth of about 4% this year (3½% GNP growth, by Western measures).

Industrial output during the first half was 4.7% above the year-earlier level. On the agricultural front, crop production is projected to rise 9% as a result of increased acreage and better weather. A grain harvest of 210-215 million metric tons is anticipated, up from 179 million tons in 1979, but still below the 1978 record of 235 million. Meat production this year, however, is projected to decline 4% to 14.8-15.0 million metric tons. This drop is attributable mainly to a fall in slaughter weights, as mid-1980 herd levels actually remain higher than a year earlier. Milk and butter production have been reduced even more sharply during the first half of 1980.

Growth of new capital investment is expected to be 3% in 1980, with a 4% rise already registered in the first half of the year. This should restrain real household income and consumption growth to approximately 2½%.

Soviet foreign trade in 1980 will be affected—for better and worse—by higher average prices for energy and metals in world markets, economic slowdowns abroad, U.S. restrictions on Soviet grain purchases, strong domestic demand for machinery and materials from abroad, and a reduced volume of petroleum exports to the West.

On balance, total exports to the West are projected to rise to over $20 billion, while imports will reach $23 billion. Soviet purchases of grain from developing countries will boost the total hard-currency trade deficit to approximately $4.5 billion in 1980. (Exports to the West during the first quarter were 75% higher than in 1979, while imports were up only 25%. This large jump in export receipts, however, was largely the result of the doubling of world oil prices and will not be sustained for the year.)

The overall Soviet current-account balance is expected to remain in surplus throughout 1980, owing to windfall gains from oil and gold sales and U.S. restrictions on Soviet grain purchases. With only moderate growth in official credits from Western governments, Soviet net debt to commercial banks will continue to decline. The estimated debt-service ratio has already fallen to less than 20%, even excluding hard-currency revenues of $4 billion from gold and arms export sales.

It is widely held that by the early 1980s, energy will become the major constraint on Soviet economic growth, with perhaps dramatic consequences for domestic politics and foreign policy. This view, however, tends to overestimate the decline ahead for oil production and underestimate the potential for inter-fuel substitution and energy conservation within the USSR and Eastern Europe. It also implies too large an impact of energy on long-run economic growth.

It is now clear that the USSR reaped an energy windfall during the 1970s, thanks to its West Siberian oil and OPEC pricing policies, and that such windfall earnings are unlikely to be seen again in the 1980s. Nonetheless, it is most likely that Soviet oil output will remain at about 10-12 million barrels per day through much of the decade (compared with an average of about 11.8 million barrels in 1979). This contrasts with some forecasts that oil output will fall to eight million barrels per day or less.

If oil production is in fact sustained at 12 million barrels per day through 1985, energy production will advance by about 2½% each year, and Soviet GNP will rise by about 3% per annum through 1985 (given normal weather conditions). With domestic oil consumption growth of only 1%—and gains in natural gas, nuclear, and hydroelectric power—the Soviet balance of payments will remain strong. Accordingly, net external debt would not rise through 1985, and the debt-service ratio would remain below 20%. If, however, oil output drops to 10 million barrels per day by 1985, domestic energy growth would fall to only 1½% per annum and exports to the West and the CMEA nations would be reduced. This scenario would necessitate an accommodating drop in annual GNP growth to 2½%, an extra $10 billion in external debt by 1985, and a moderate rise in the debt-service ratio.

Donald W. Green

Exchange Rate Protectionism

There is at present an ongoing debate in the United States as to whether U.S. economic policies should become more protectionist. Some industries are pressing for protection from what they consider to be unfair competition or foreign encroachment.

Many of these same industries calling for protection have, however, received support from exchange-rate policies that have resulted in a decade of dollar weakness. The "veiled" protection provided by this depreciation has been very real, albeit less apparent. It has arisen from monetary and fiscal policies not specifically designed to protect particular industries. Nonetheless, it has promoted the interests of certain U.S. industries at the expense of other industries (and consumers) just as effectively as legislated trade barriers. At the same time, such "exchange-rate protectionism" may have also contributed to exchange-rate instability by shifting long-run equilibrium exchange rates.

Long-run equilibrium exchange rates—the relative price of national currencies—are determined by relative supplies and demands for currencies, both at home and abroad. Long-run supply is determined by the policy actions of a country's monetary authorities, while long-run demand is determined by such variables as prices, interest rates, and GNP.

Certain industries in a particular country, owing to endowments of natural resources or superior technology, possess a *comparative* advantage over their foreign competitors in certain products. Presumably, trade with foreign countries increases the productivity of a country's resources by permitting a concentration of production in those industries where a comparative advantage exists.

In an unprotected market, an industry's comparative advantage gives rise to a *competitive* advantage, which in turn arises from the industry's pricing policies. For example, suppose that, because of more efficient technology, Japanese industry A has a comparative advantage over U.S. industry B in producing a specific product. Industry A's comparative advantage would show up as a competitive advantage if industry A charged a lower price than industry B, or if its profits were higher.

The exchange rate, however, is crucial in determining whether a particular industry translates its comparative advantage into a competitive advantage. But although the exchange rate directly affects specific industries, it is an external factor beyond any single industry's control. Using the example above, suppose U.S. monetary policy (relative to Japanese) induces a dollar depreciation. With Americans receiving less yen per dollar and Japanese receiving more dollars per yen for a particular period of time, the exchange-rate depreciation increases the price of the product imported from Japan and decreases the price of the product exported to Japan. Consequently, the policy-induced exchange-rate depreciation lessens, or even obliterates, Japanese industry A's competitive advantage, transferring it to U.S. industry B where no comparative advantage exists.

Thus, an independent U.S. monetary policy action essentially imposes a non-legislated tariff on Japanese imports. And this policy-induced exchange-rate protection is as "artificial" as any legislated form of trade protection in that resultant market prices obfuscate industrial pricing behavior.

The cost of exchange protectionism

In any economy, there are market participants who prefer either a higher or a lower exchange rate. Consumers, as well as producers who import inputs to production, prefer exchange-rate appreciation. A depreciation is favored by exporters who benefit from the reduced price of their product abroad and by producers competing with foreign products in the domestic market.

Exchange-rate protection will thus be costly to those groups benefiting from appreciation. It also has a broader impact by altering the relative industrial shares of a country's GNP. A depreciation will lower domestic production in industries that utilize foreign inputs in their production processes, while boosting production in industries whose final product competes with the foreign counterpart in domestic and foreign markets. Consequently, industries benefiting will increase their relative share of national product at the expense of those industries (and consumers) that would benefit from a currency appreciation.

A policy-induced depreciation also has repercussions abroad, where a defacto currency appreciation is manifested. It alters the relative shares of the foreign country's national product, although the inter-industry transfer is reversed. Foreign consumers become better off, obtaining lower cost imports, as do foreign industries that import inputs to their production processes. Again, these two groups gain at the expense of exporters and producers competing with foreign products.

If the protected domestic industries are those with relatively obsolete technology and low productivity, then long-run, domestic economic growth is impaired. Consequently, a policy-induced depreciation may lead to further real exchange-rate depreciation and instability in the long-run equilibrium exchange rate by increasing foreign economic productivity relative to domestic productivity. This begins a vicious cycle in which further exchange-rate depreciation is triggered and gaps in relative productivity growth are widened.

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CHASE

International Finance

Vol. XV, No. 19
September 29, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

9/29/80 /
B1900-1 U

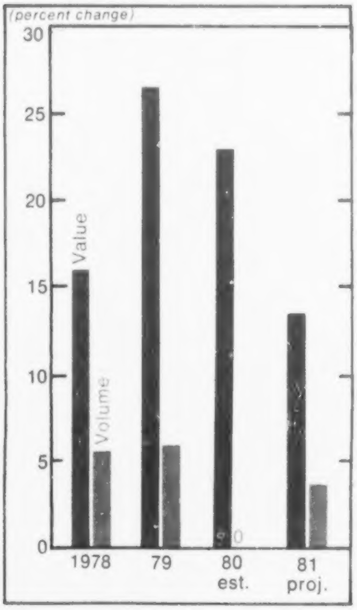
World Trade Growth Decelerating

The volume growth of world trade will slow sharply this year, after having expanded at a relatively steady and moderately robust annual rate of 5%-6% from 1977 through 1979. The precise amount of slowdown is still somewhat uncertain. The IMF and GATT have both projected trade volume in 1980 to be 2%-3% higher than in 1979, but data for the first six months of the year suggest a much slower rate of increase. Indeed, the volume of world trade this year appears likely to be essentially the same as in 1979. This translates into a decline of about 1½% on a fourth-quarter-to-fourth-quarter basis. Given the apparent sharp falloff in trade during the second quarter—perhaps as much as 5% on a seasonally adjusted basis—even this gloomy assessment may turn out to be too optimistic if the recovery in trade expected for the fourth quarter fails to materialize.

The current slowdown in world trade differs from that of 1974-75 in two ways. The first is the closer synchronization in the current period of both the trade cycle and the cycle of overall economic activity in the industrialized countries. In 1974-75, because of heavy inventory building of raw materials and maintenance of relatively high rates of import growth by the developing economies in the early stages of the downturn, changes in the volume of trade lagged well behind changes in the level of output in the industrialized countries. Second, the current trade slowdown is likely to be milder than the 1974-75 downturn. The volume of world trade in 1975 was down 5% from the 1974 level. Although the drop in trade volume in early 1980 does appear to have been relatively sharp, the absence of speculative excesses in inventory accumulation and the lesser magnitude of the current slowdown in global economic activity in comparison with the 1974-75 recession suggest a quicker recovery of world trade this time.

Still, the pace of expansion of world trade during 1981 appears likely to be no more than moderate. Current projections suggest that the rate of increase in the level of overall economic activity in the industrialized economies next year will be relatively modest for a recovery period. Accordingly, the volume of world trade is unlikely to grow by more than 5%-6% between the fourth quarter of 1980 and the fourth quarter of 1981. If so, world trade in 1981 would only be about 3½% higher than the level expected for 1980.

Growth of world trade



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German central bank again moves with restraint in easing monetary policy.

The German Bundesbank has once again exercised caution in relaxing monetary policy. The central bank reduced the Lombard rate by 50 basis points to 9% and made available another short-term credit facility to the banking system at 1% below the Lombard rate. These measures follow the slight relaxation in August, when the Bundesbank also lent funds below the Lombard rate and cut reserve requirements. While the domestic economy clearly requires monetary relaxation, concern for the mark's position in foreign-exchange markets is precluding further interest-rate reductions. The authorities are expected to adopt a wait-and-see posture. If there is no adverse reaction on foreign-exchange markets and U.S. dollar rates hold stable or decline, further interest rate reductions are likely. But if the latest cuts lead to heavy losses of exchange reserves, further rate reductions will probably be postponed until underlying influences are again seen as favorable to the DM, probably around the turn of the year.

Norway's accelerating inflation creates labor unrest, but strong anti-inflation measures unlikely.

Norway's oil output continues to grow rapidly, reaching 103 million barrels in the first half of 1980. Oil earnings have thus shifted the current account into a surplus of 3.8 billion kroner for the January-June period, compared with a kr. 3.0-billion deficit in the first half of 1979. Norway's proven oil and gas reserves have recently been revised upward to 2.4 billion tons, which ensures that the country will be exporting oil for a long time to come. Traditional industries, however, are faced with declining competitiveness. The spring 1980 wage accord allowed for slight wage rises that would have boosted competitiveness. But the wage agreement assumed small price increases in 1980, and inflation has accelerated from 4.7% at yearend 1979 to 11.4% in August—with continued acceleration probable. The resultant squeeze on real incomes has fueled labor militancy and higher wage demands are imminent. The situation has been aggravated by the preferential treatment of North Sea oil workers who will receive pay rises of about 30% this year. With elections only a year away, the Government is unlikely to impose unpopular anti-inflationary measures. The authorities have so far been content only to squeeze private-sector credit by raising bank reserve requirements and interest rates.

Spanish current-account gap widening, creating problems for the peseta.

The recent resignation of Spain's deputy prime minister and minister of economy Fernando Abril Martorel resulted in a general cabinet reshuffle and the appointment of a new economic minister, Leopoldo Calvo Sotelo. No change in economic policy is foreseen, however, despite serious concern over the economic situation. The current account recorded a deficit of $2.4 billion in the first five months of 1980, in contrast with a surplus of $60 million for the year-earlier period; a deficit of at least $4 billion is likely for the year as a whole. The peseta has weakened accordingly on foreign-exchange markets, falling from 66 pesetas per U.S. dollar at the start of the year to 73. This weakness is likely to renew inflationary pressures that had moderated somewhat in the second quarter, pressures that will be heightened further by a larger-than-budgeted public deficit and continued rapid money growth. Recent policy statements by Prime Minister Suarez suggest reflationary measures in 1981. These would sustain high inflation next year, despite the expectation of continued economic weakness and high unemployment.

Korean economy experiencing severe contraction.

The Korean economy is in the midst of a sharp recession. Real GNP growth began declining last year, and in the first quarter of 1980 was negative 4%. It is therefore expected that economic growth for the current year as a whole will be negative. A poor crop is an important contributor to the economic deterioration, but the basic problem is industry. Excessive investment in heavy industry during the late 1970s overheated the economy. In addition, the country's exports suffered a loss of competitiveness and declined in volume terms last year. The sharp oil price hikes of 1979/80 have aggravated the situation and are contributing to a current-account deficit that may exceed $5 billion this year. The Government's response to these difficulties has been to devalue and float the won, pursue a tight fiscal policy, and merge several over-expanded industries. A new set of measures announced in September includes lower interest rates and credits for the housing industry.

Mexico's rapid economic growth accompanied by rising inflation and strains on capacity.

Mexican President Lopez Portillo, in his recent State of the Nation Report, summed up Mexico's current economic position. He expressed satisfaction with an annual economic growth rate of approximately 8%, but tempered his enthusiasm with concern about a higher-than-expected rate of inflation. The rate of increase in consumer prices has risen steadily from an annualized 20% at end-1979 to nearly 26% in June. The country's rapid economic growth has also resulted in serious strains on productive capacity. Electrical brownouts have occurred, and the country's transportation system is severely strained. Nonetheless, the pace of job creation has increased, the population growth rate has fallen to less than 3%, and proven oil and gas reserves have climbed from 50 to 60 billion barrels.

Pakistan's rapid economic growth likely to continue, but inflation rate set to accelerate.

In fiscal 1979/80 (ended June 30), Pakistan's real GDP is reported to have grown 6.2%, slightly faster than the previous year and nearly twice the rate of growth achieved in the 1974-77 period. Agricultural production increased 6%, while manufacturing output rose 8.1%. The outlook for economic growth during fiscal 1980/81 is favorable, but actual growth is unlikely to match last year's performance. Manufacturing should continue fairly strong, unless balance-of-payments constraints force a further tightening of controls over private-sector imports. Agricultural growth is likely to slow down, however, partly because of the large reduction in subsidies of fertilizer prices. The Pakistani consumer price index was up only 11% on a year-over-year basis in April, but the World Bank estimates that the annual rate of inflation actually reached about 20% in early 1980. The government decision to pass on to consumers the higher cost of imported oil, together with recent or planned increases in the official prices for sugar, flour, and rice, suggest that last year's inflation rate will probably be exceeded in the current fiscal year. But if the reduction in subsidies results in a lower public-sector deficit and a lower rate of domestic credit expansion, the longer-term inflation outlook will be improved.

Indonesian oil and gas earnings growing rapidly.

Indonesian net foreign-exchange earnings from oil and gas will reach about $11 billion in fiscal 1980/81 (ending in March), compared with earnings of $4 billion only two years earlier. LNG exports, expected to net $1 billion this year, account for an increasing portion of total receipts. Oil output has been declining from its peak of 1.69 million barrels per day in 1977 to its current level of 1.56 million barrels daily, although it is expected to rise slightly next year. Oil and gas exploration has stepped up in response to higher prices, and a number of new discoveries have been made in the last several months. Nonetheless, oil export volume, which should exceed 400 million barrels this year, may remain at this level for the next few years, despite moderate increases in production, because domestic consumption is expected to continue growing by about 12% per annum. Thanks largely to oil and gas earnings, Indonesia posted a current-account surplus of $2 billion in fiscal 1979/80 and may chalk up a surplus of $3 billion this year. In addition, foreign-exchange reserves are currently estimated at $7 billion and could reach $10 billion in 1981.

OPEC meeting concludes with some progress toward price reunification.

The oil, finance, and foreign affairs ministers of the OPEC member nations achieved a partial compromise at their Vienna meeting earlier this month. The meeting sought to reunify oil prices in preparation for the implementation of a long-term price-fixing formula in 1981. The formula calls for quarterly increases in Saudi marker crude tied to an average OECD growth and export inflation rate and an exchange-rate adjustment for the U.S. dollar. Sharp differences emerged between the OPEC moderates (Saudi Arabia and Iraq) and the radicals (Iran, Libya, and Algeria). The Saudis refused to discuss changes in their pricing or production until the hawks agreed to reduce their price differentials and/or premiums. The radicals insisted that the Saudis first agree to raise prices and cut output. The compromise reached has the Saudis boosting their light crude price from $28 to $30 per barrel—retroactive to August 1—but maintaining current output through the fourth quarter. In exchange, other members agreed to freeze their prices at current levels. A reunification of prices could occur by yearend, but the conflict between Iran and Iraq adds a serious new uncertainty.

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Money Supply Control Remains Elusive

The surge in money growth in recent months has been well in excess of the short-run growth targets set by the Federal Reserve. This contrasts to the huge shortfall in money growth relative to targets that occurred during the spring. Indeed, the volatility in money growth over the last six months has been enormous by historical standards.

Interestingly, this increased volatility in money growth has appeared less than a year after the Federal Reserve altered its open market operating procedures to put greater emphasis on controlling bank reserves. The announced purpose of this shift, of course, was to increase the Fed's ability to attain its monetary growth objectives.

Most analysts believe that the unusual behavior of the money supply over the last six months is directly related to the variability in the economy during this period. For example, from February to May, when M1-B—which includes currency and checkable deposits at banks and thrift institutions—declined at an annual rate of 5%, retail sales plummeted by more than 16%. And from May to August, when M1-B grew at an annual rate of 17%, retail sales jumped by over 30%.

Even given the behavior of the economy, however, the question still arises: Why hasn't the "new" Fed policy strategy resulted in action that offsets, at least to a greater extent, the effects of short-run volatility in total spending on short-run money supply growth? The answer, at least in part, stems from two observations. First, the Federal Reserve's ability to control the money supply in the short run through open market operations is significantly limited under the current reserve-requirement system. Second, the Federal Reserve still sets a target range for the federal funds rate—albeit a much wider one than before the announced policy change—that constrains open market operations.

The ability of the Federal Reserve to control the money supply under a reserves-targeting policy is limited because the Fed cannot always control the total amount of bank reserves in the short run. Under the current reserve-requirement system, the dollar volume of banks' reserve requirements is based upon deposit balances held two weeks earlier. Thus, banks can do nothing to alter their required reserves during any given week. And since the volume of excess reserves is usually relatively small, the total volume of bank reserves in any given week is often predetermined. Thus, changes in total reserves are *affected by*, and do not necessarily *cause*, changes in deposits.

The actual "causal chain" from reserves to money under the Fed's new policy strategy involves altering the supply of *nonborrowed reserves*—created mainly through open market operations—relative to total reserves. In following a reserves-targeting policy, the Fed sets both a nonborrowed reserves target and a total reserves target believed to be consistent with its money supply target.

Determining the total reserves path and nonborrowed reserves path consistent with some money supply path is a tricky task. There is significant slippage in the relationship between total reserves and the money supply, since reserve requirements vary with respect to both the size of deposits and the type of deposits—some of which are not included in the money supply. Changes in the public's demand for currency relative to demand deposits also affect the relationship between reserves and the money supply.

Even given a total reserves path consistent with the money supply target, however, estimating the nonborrowed reserves path also consistent with this money target is difficult. Under these circumstances, setting a target for nonborrowed reserves is essentially equivalent to setting a target for borrowed reserves. But bank borrowings from the Fed discount window generally increase (decrease) when the federal funds rate rises (falls) relative to the discount rate. Thus, in setting a given nonborrowed reserves target, implicit assumptions are made regarding where the funds rate must trade relative to the discount rate.

Moreover, the Fed recognizes that changes in total spending over the targeted period will, other things equal, affect money supply growth. All of this implies that to set a short-run nonborrowed reserves target consistent with some money supply target, the Fed must first project total spending, and then estimate, given this projection, what levels of both the discount rate and the funds rate will result in the targeted money growth. Even if the Fed could accurately forecast total spending, the latter estimates are subject to much uncertainty.

It is doubtful, however, that the Federal Reserve—or for that matter anyone—can accurately forecast total spending in the short run. Thus, even if the Fed somehow stumbled across the nonborrowed reserves target consistent with its money supply target, *given its projection for total spending*, inaccurate forecasts of total spending would result in deviations of money growth from target.

Finally, open market operations designed to achieve various reserves targets are still subject to the proviso that the weekly average funds rate does not move outside a specific target range. Of course, this target range has been widened considerably since the new policy was announced.

Even the new target range for the funds rate may not be large enough, however, if total spending fluctuates widely, as it has over the past six months. For example, some Federal Reserve Board governors have suggested that for the Fed to have achieved its money growth targets this spring, the funds rate would have had to fall to "unacceptable" levels. And similar constraints on upward movements in the funds rate may currently be affecting the resolve of the Fed to hit its reserves targets. On balance then, it is understandable why, given the volatility in the economy, the Federal Reserve has had difficulty controlling the short-run behavior of the money supply.

Thomas A. Lawler

Europe, Canada & U.S.

Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		3 months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply (M_1)	September 24, 1980		current monetary conditions	
Austria	Strong first half leads to upward revision in official economic growth forecast for 1980 to 3.5%.	Feb.	+ 4.3%	73.1	+ 1.5%	July	4,176	+ 8.0%	2.0	0	Jan.-July current-account gap 27.6 bn. schillings, vs. 11 bn. year ago.	June	+ 7.1%	Apr.	+ 6.5%	6.75%	.0781	Money supply remains tight.	**Austria**
Belgium	Recession under way, with June industrial output down 0.9% from year ago; inflation easing.	May	− 6.5%	117.7	+ 3.5%	July	8,560	+ 48.0%	1.4	0	Jan.-May current-account gap was 74 bn. francs, three times year-earlier figure.	July	+ 6.6%	Mar.	− 1.0%	12.00%	.0345	Interest rates easing gradually.	**Belgium**
Britain	Recession intensifies; July industrial output down 8.1%; August unemployment rate at 7%.	July	− 8.5%	446.0	+ 0.9%	July	22,241	+ 9.9%	2.0	820	Jan.-Aug. current-account balance shows surplus of £ 244 million.	Aug.	+16.3%	June	+ 2.8%	16.00%	2.4010	Money growth above targets, but future cut in MLR likely.	**Britain**
Denmark	Economic activity declining, with unemployment trending upward.	Apr.	+ 2.7%	63.2	+ 3.5%	July	3,001	− 23.5%	1.8	0	Jan.-June current-account gap was 9.5 billion kroner.	June	+13.3%	Apr.	+ 5.9%	12.00%	.1798	EMS membership forces continued tight money conditions.	**Denmark**
Finland	Economic growth slowing, but still sufficiently high to reduce unemployment.	May	+ 2.7%	43.5	+ 6.7%	July	2,040	+ 0.3%	1.6	87	Jan.-July trade account shows deficit of 2.9 billion markkaa.	June	+11.2%	Apr.	+15.9%	9.25%	.2745	Monetary policy remains restrictive.	**Finland**
France	Economic growth has begun declining; surveys indicate pronounced business pessimism.	June	0	526.5	+ 3.4%	July	27,255	+ /1.5%	2.3	0	Trade gap remains large, but reduced import growth anticipated.	July	+13.6%	May	+ 8.5%	9.50%	.2395	Pressure on franc forces maintenance of high interest rates.	**France**
Germany	Economy dips sharply in second quarter, confirming earlier predictions of recession.	July	− 2.4%	798.5	+ 4.4%	July	50,859	+ 4.2%	3.1	0	Decline in real value of DM should help exports in 1981.	Aug.	+ 5.5%	June	+ 1.6%	7.50%	.5550	Lombard rate cut to 9%; more easinglikelyincomingmonths.	**Germany**
Greece	Economy expected to record zero growth in 1980; mild recovery foreseen for 1981.	May	0	37.5	+ 3.5%	June	830	− 13.7%	1.2	143	Current-account gap of some $2.5 billion anticipated for 1980.	June	+27.0%	Dec.'79	+17.4%	20.50%	.0234	Credit conditions highly restrictive.	**Greece**
Ireland	GDP expected to increase only slightly this year.	Mar.	+ 0.1%	15.5	+ 1.9%	July	2,486	+ 14.7%	2.6	0	Despite strong exports, current-account gap may hit 750 mn. pounds in 1981.	May	+20.2%	June	− 0.4%	16.10%	2.0960	Interest rates cut, but pound holds firm.	**Ireland**
Italy	Sharp economic downturn in May-June; recession likely to continue into 1981.	July	+12.5%	323.6	+ 4.9%	July	23,440	+ 26.9%	2.8	0	Current-account gap may top $5 billion this year.	Aug.	+21.6%	Apr.	+19.9%	15.00%	.001168	Credit remains restrictive.	**Italy**
Netherlands	Zero economic growth forecast for 1980; restrictive budget proposed for 1981.	June	0	156.1	+ 2.3%	July	11,226	+ 48.6%	1.6	0	Current-account deficit running nearly double last year's level.	July	+ 7.1%	May	+ 4.5%	8.50%	.5103	Interest rates ease moderately.	**Netherlands**
Norway	Rising oil output sustains rapid economic growth, but inflationary pressures mount.	June	+ 4.9%	46.7	+ 3.2%	July	4,727	+ 20.9%	3.3	0	Jan.-Aug. current account shows surplus of 2 bn. kroner, vs. kr. 1.1 bn. year ago.	July	+10.5%	Apr.	+ 6.0%	9.00%	.2058	Bank reserve requirements raised to curb inflation.	**Norway**
Portugal	Economic and political uncertainty prevails in advance of two upcoming elections.	Dec.	+ 6.7%	15.7	+ 3.2%	June	445	− 28.7%	0.7	155	Continued tourism strength may keep '80 current-account gap below $800 mn.	Apr.	+19.5%	Jan.	+26.3%	18.00%	.0200	Strong credit growth expected to result in credit tightening.	**Portugal**
Spain	Economic activity at low level, with agricultural output the only bright spot.	Feb.	+ 8.5%	196.0	+ 1.5%	June	11,784	− 2.3%	4.5	269	Bank of Spain accumulating reserves as peseta weakens.	May	+13.3%	May	+ 8.3%	8.00%	.0137	Credit generally available.	**Spain**
Sweden	Government plans to cut public spending and reduce budget deficit to 1% of GDP.	May	−19.0%	104.5	+ 3.8%	July	3,525	− 5.6%	1.3	0	Current account in large deficit; foreign debt mounting.	July	+13.2%	Dec.	+16.3%	10.00%	.2407	Bond rates raised to aid in financing public deficit.	**Sweden**
Switzerland	Real economic growth expected to be sustained throughout 1980.	Mar.	+ 9.0%	101.4	+ 0.7%	July	12,563	− 8.7%	3.9	0	Current-account gap virtually certain for 1980—first since 1965.	Aug.	+ 4.2%	June	− 8.2%	3.00%	.6056	Central bank continues to tighten monetary conditions.	**Switzerland**
Canada	Economy declines sharply in second quarter; housing and auto sales very weak.	June	− 2.0%	225.9	+ 2.7%	July	3,041	− 5.9%	0.6	0	Higher export prices enhance trade position.	Aug.	+10.7%	July	+ 3.8%	11.02%	.8586	Interest rates ease slightly.	**Canada**
United States	Signs of recovery from recession still unconfirmed.	Aug.	− 7.9%	2,369.0	+ 2.3%	July	10,660	+ 22.1%	0.5	0	Positive current-account balance expected in 1980.	Aug.	+12.8%	Aug.	+ 4.3%	10.00%	—	Interest rates and money growth have risen sharply.	**United States**

World Interest Rates

market rates of Sept. 24, 1980; bond yields as of Sept. 19, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	11.02	16.00	12.00	9.50	7.50	15.00 penalty rate 18.00	8.50	3.00	8.25
Day-to-Day Money	11.125 Sept. 25	9.50	15.75	7.45	11.50	9.00	16.875	9.00	6.25	11.562
Treasury Bills 91-day, Middle Rates	10.15	10.73	14.3125	12.35	12.39 one-year	n. a.	14.798 66-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	10.875 finance paper	10.85 finance paper 15% tax w/h	13.793	11.60 Certified	12.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.10	10.80 15% tax w/h	15.00	11.60 Certified	not traded	9.90	20.20	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.32	13.40	12.95	11.141 20% tax w/h	12.95	8.09	15.69	10.32	4.89	8.59
Industrial Bonds prime, long-term, new and old issues, average yield	12.55 Aa Industrials	14.00	13.72	14.626	13.81	8.34	15.94	11.15	5.70	7.36
Bank Short-Term Rate to Best Borrowers (prime rate)	12.50	12.25	17.00	15.75	13.85	11.50	19.50	11.50	5.50	8.50
Bank Time Deposits 3-month	11.00 Cert. of Dep.	10.70 Cert. of Dep.	15.5625	12.30	12.00	8.25	10.75	10.125 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	12.125	no market	15.875	no market	12.125	8.6875	no market	10.125	5.625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8586	2.4010	.0345	.2395	.5550	.001168	.5103	.6056	.004629
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *P*	3.50 *D*	FLAT	FLAT	3.375 *P*	13.00 *D*	2.00 *P*	6.50 *P*	1.25 *P*

Eurodollar Deposits

(London, interbank bid)

	Sept. 25
7-day	11.25
1-month	11.625
3-month	12.00
6-month	12.25

International Arbitrage

(3-month, hedged) **+** *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .046
U.S.-Canada Treasury Bills	−1.41
U.S.-Canada Finance Co. Paper	−1.075
Eurodollars-U.K. Local Auth. Deposits	+ .125

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.625
Over 7 yrs.	12.875
DM Bonds	
7 yrs. and under	8.375
Over 7 yrs.	8.50

Gold Price

London afternoon fixing

710.50

(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.8 (Aug.)	10.7 (Aug.)	16.3 (Aug.)	13.6 (July)	5.5 (Aug.)	21.6 (Aug.)	4.2 (Aug.)	7.7 (July)
Industrial production*	−7.6 (Aug.)	−2.0 (June)	−8.5 (July)	0 (June)	−2.4 (July)	12.5 (July)	9.0 (Mar.)	6.5 (July)
Trade balance† *(billions of local currency units)*	−$1.85 (July)	C$0.35 (July)	£0.06 (Aug.)	−FF4.89 (Aug.)	DM0.10 (July)	−Lit.1,770 (July)	−SF0.99 (July)	¥75 (Aug.)
Money supply (M_1)*	4.3 (Aug.)	3.8 (July)	2.8 (June)	8.5 (May)	1.6 (June)	19.9 (Apr.)	−8.2 (June)	0.6 (June)
Velocity of money $(\dot{M}_1)$*	3.3 (Mar.)	6.4 (Mar.)	11.7 (Mar.)	n. a.	7.5 (Mar.)	4.3 (Mar.)	n. a.	−0.2 (Mar.)
Reserves minus gold *($ million, change from previous month)*	−90 (July)	−278 (July)	−40 (July)	1,514 (July)	1,404 (July)	2,940 (July)	−1,869 (July)	157 (July)

* Percent change from 12 months earlier

† Figures are only for the month indicated

Chile Reaping Benefits of Economic Reform

Since bottoming out in 1975, the Chilean economy has exhibited buoyant growth in output, employment, and real wages. The public sector's financial position has improved greatly; inflation has been reduced from the 400% level to the current 30%; and international reserves, negligible in 1975, have hit a record level of $2.4 billion.

Chile's impressive economic turnaround has occurred despite weak prices for key copper exports during most of the period, soaring oil import costs, and a heavy external debt service burden. The reason is the shift in economic orientation introduced by the military leadership, which assumed power in late 1973. Specifically, the Government of Augusto Pinochet replaced the extreme interventionist policies of the former Allende Administration with a free-market approach, with the goal of achieving a more efficient allocation of resources. This strategy required a total restructuring of the Chilean economy. The former government's stifling presence in the development process needed to be curtailed, and the country's exposure to international trade and capital had to be increased. To date, Chile has made significant progress in the needed restructuring, as recent developments in the fiscal, monetary, and external-payments areas demonstrate.

Progress on a number of fronts

On the fiscal front, the authorities have finally achieved the objective of eliminating the central government budget deficit, a goal set in 1973 when the shortfall equalled an astounding 24% of GDP. The deficit has been systematically reduced and converted into a surplus that was equivalent to 1.7% of GDP in 1979. The shift occurred as the result of tax reform measures, limitations placed on central bank lending to the Government, and, most importantly, reform of the administration and pricing policies of state enterprises, whose chronic deficits had previously represented the largest drain on the fiscal budget. Still, central government expenditures have not really declined in relation to GDP, and the authorities hope to reduce further the size of the public sector in coming years by holding the growth of public spending to a rate less than the expansion of national output.

In the financial sphere, the Government has opened up the domestic market to foreign banks and encouraged local financial institutions to borrow abroad. This liberalization has been accompanied by gradual but sizable reductions in the legal reserve requirement on 30-89-day time deposits and by a decrease in the public sector's claims on domestic credit. These actions have enhanced the efficiency of the capital market both by expanding the amount of loanable funds available to the private sector and by lowering their cost. Accordingly, the private sector's share of domestic credit rose from 59% in 1978 to 73% in 1979, while the lending rate on 30-day loans declined from a monthly average of 5.3% in 1978 to 4.1% in 1979 and to 3% in May 1980.

The inflows of foreign capital, induced by a large differential between domestic and foreign interest rates, has also had a major expansionary impact on liquidity. In 1979 alone, the net foreign asset position of the domestic banking system shifted from minus 11.4 billion pesos to a positive 12.4 billion pesos. The foreign inflows were a principal cause of the 65% growth in domestic liquidity last year. So far this year, the money supply has sustained just as rapid a pace of increase, a product of the renewed effect of international reserve accumulation.

The challenge before the monetary authorities is to pursue a sufficiently stimulative monetary policy that will keep interest rates low to spur investment and economic activity without fueling inflation or stimulating excessive import demand. Yet control of the money supply—and of inflation—is becoming more difficult as the authorities move to eliminate all restrictions on foreign capital inflows. (Currently, external borrowings are still not permitted for periods of less than two years.) The sources of the growing difficulty are precisely the open capital market and fixed-exchange rate regime; any attempts to curb internal credit growth will now be offset by increases in international borrowing.

Recent economic performance

Chile's economic policies were instrumental in enabling the country to achieve yet another year of strong economic growth last year. Real GDP rose 8.5%, the third consecutive year in which domestic output averaged an increase of more than 8%.

Output in the construction sector grew 26% last year, compared with an average of 3.5% in the previous two years, a direct result of a delayed recovery of the housing mortgage market. The improvement in the construction sector, moreover, was the main force behind the decline in the unemployment rate to 12.7% in December 1979 from 14.8% at end-1978. Agricultural production posted gains of nearly 8%, compared with a 2.5% decline in 1978, while the mining sector grew 3%, after recording no growth in the previous year. Industrial production rose 9% in 1979, a pace that has been sustained since 1976.

There are indications that overall economic growth will be more moderate this year. During the January-June 1980 period, manufacturing output rose by a modest 3.7%, down from 10.7% in the same period

Chile Reaping Benefits of Economic Reform (continued from page 7)

last year. This is the result of strong import competition and the emergence of capacity constraints. The deceleration in manufacturing, coupled with weakness in agriculture and mining, suggest that the economic growth rate may fall to about 5% for 1980 as a whole.

Chile's success in slashing its inflation rate from its triple-digit level in the mid-1970s to 30% by end-1978 was primarily the result of fiscal improvements that dampened pressure on money growth. Last year, the monetary authorities concluded that the principal inflationary pressures remaining were externally fueled, since the economy was so open to international trade and capital movement. The authorities felt that by fixing the peso exchange rate to the U.S. dollar, Chilean inflation could be reduced to the level prevailing in the United States. Consequently, the system of pre-announced mini-devaluations that had been in effect since 1978 was abandoned in June 1979, and the peso was devalued by 6% and fixed at the present rate of 39 pesos per U.S. dollar. Rather than leading to lower inflation, however, the result was a temporary acceleration in inflation. The rate rose to nearly 40% by late 1979 as prices of both imports (especially of oil) and exports (mainly of copper) increased, and as capital inflows rose substantially. However, a declining trend in the monthly price increments has emerged this year. Inflation, as measured by the consumer price index, rose at an annual rate of 30% during the first seven months of 1980, down from 36% during the same period in 1979. And the improvement was even more pronounced in wholesale prices, which registered annualized increases of 32% in the first half of 1980, versus 56% in the year-earlier period.

On the external front, the combination of strong domestic activity, a large jump in the price of imported petroleum, the adoption of a fixed exchange rate, and continuation of tariff reductions boosted import expenditures from $2.5 billion in 1978 to $3.9 billion in 1979. This was matched, however, by a sharp increase in exports from $2.4 billion to $3.8 billion, a result of both a large jump in copper prices from an average of 62¢ per pound in 1978 to 90¢ per pound in 1979 and a 65% rise in non-traditional exports.

While statistics for the January-July 1980 period indicate still-rapid growth for exports and imports (export shipments rose 48% above the previous year's level and registered imports increased 40%), their growth rate has slowed more recently. The export slowdown is the result of a combination of two forces: declining copper prices since the first quarter—the consequence of economic weakening abroad—and the negative impact on the competitiveness of non-traditional exports of present exchange-rate policy—which has led to an appreciation of the peso of at least 20% in real terms between June 1979 and July 1980. Import growth, on the other hand, is lessening as a consequence of the slower pace of domestic economic expansion. Thus, exports could reach $5 billion in 1980, while imports may climb to $5.3 billion. The resultant trade deficit, when combined with a projected $1-billion deficit in the services and transfers account, should yield a current-account deficit of some $1.3 billion this year, up from the $900-million deficit posted in 1979.

Foreign capital inflows, primarily private, are expected to meet the country's financial requirements with ease. They are also expected to boost international reserves to $2.8 billion by yearend. With this scenario, Chile's total foreign debt will rise to about $10.3 billion by the end of 1980, up from $8.5 billion at end-1979. Such an increase, however, represents a decline in the debt burden relative to national income and exports.

Growth prospects favorable

The opening up of the Chilean economy, combined with the introduction of a free-market mechanism for resource-allocation purposes, has led to rapid economic expansion and laid the foundation for sound and self-sustaining growth. Real economic growth in excess of 6% per annum over the next two to three years is a possibility. But this assumes maintenance of a stimulative economic policy that will boost investment and an exchange-rate policy that supports vigorous economic growth—especially in manufacturing—without undermining export-oriented industries and incurring large current-account deficits. Conduct of such a stimulative policy, however, would mean that Chilean inflation would be unlikely to drop to the world level, although a gradual decline in the rate of price increase could materialize if import and export prices were to stabilize.

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CHASE

International Finance

Vol. XV, No. 20
October 13, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

10/15/80 /

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A Profile of the U.K. Recession

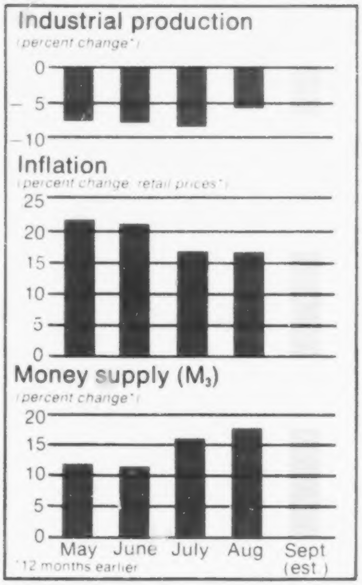
The British economy is now deep into recession. Industrial output has declined steadily over the course of the year (excepting a small uptick in June), and the index of retail sales volume stands at about the level prevailing in 1976. Moreover, the unemployment rate rose to 7.4% in September from 7.0% in August. The recession appears unlikely to reach its trough before yearend, and will result in a decline of slightly less than 2% in real GDP for 1980 as a whole.

The downturn has been accompanied by some good news. The balance of payments has shown a large surplus for the last four months, with export volume holding up well in the face of continuing sterling strength. And the rate of inflation has come down. September retail prices were up some 17% from their year-earlier level, compared with 21.9% in May.

These developments would appear to suggest an imminent reduction in Britain's high interest rates—the Bank of England Minimum Lending Rate (MLR) is now 16%. Indeed, the Thatcher Government is under considerable pressure to ease rates. But such pressure is likely to be resisted, largely because of the alarming increase in the money supply. Sterling M_3 increased by more than 9% from June through September, with the September money stock estimated to be up 18% from its year-earlier level. The supply of credit to the private sector remained reasonably strong under the "corset" lending restrictions, despite the high interest rates. And when the corset restrictions were lifted in June, official figures for credit and the money supply jumped. With the Government's borrowing requirement expected to grow once more after having turned down in September, there will be little scope for significant reductions in the MLR in the near term, at least not before the money supply is brought under control.

The prospects for wage inflation are perhaps the most encouraging on the U.K. scene. Some private wage settlements have come through in single digits, with several more likely over the next few months. And although high wages in the public sector remain a problem, there are signs that the Government is preparing to limit annual public pay raises to a maximum of 10%. There is concern, however, that labor may unleash large new demands once economic recovery is under way. The overall inflation outlook is similarly encouraging, with several qualifiers: Part of the recent reduction in inflation came from an erosion of profit margins, which must eventually be restored, and monetary growth continues rapid. Nonetheless, the success in reducing inflation to date gives the Thatcher Government a badly needed dose of credibility.

Selected U.K. economic indicators



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New French budget underscores commitment to curbing inflation.

The French budget proposals for 1981 signal no change in economic policy. A reduction in inflation remains a priority. To this end, a restrictive monetary policy will be pursued in support of a firm franc. The budget deficit is projected at 29.4 billion francs next year, compared with an expected shortfall of nearly 40 billion francs in 1980. At the same time, however, a series of measures will be implemented to help ease the impact of recession. In each of the next five years companies will be able to deduct 10% of their investment expenditures from taxable profits. Tax thresholds will be raised in line with inflation to protect individuals from real growth in their tax burdens. The Government has already announced a one-time increase in child allowances and pensions costing one billion francs. In addition, a one-billion franc support package has been directed at the export sector. The authorities are hoping that these measures will secure 1.6% real GDP growth in 1981, compared with the official projection of 2.2% growth this year. They also anticipate that inflation will average 10.5% in 1981 and drop to 9.5% by yearend.

Ireland's tight money policy triggers recession, but with little abatement of inflation.

Since December 1979, the Irish Government has been fighting inflation with monetary restraint, having abandoned its previous expansionary policy. The tight money policy has pushed the economy into recession. The latest survey of industry shows that 43% of employers reduced their workforces in August and 59% had orders below their normal levels. So far, the policy seems to have had little impact on inflation, which is still running at an annual rate of about 20%, and which will be fueled further if the new wage agreement is implemented. Present proposals would give workers a wage increase of almost 9% for the next nine months, to be followed by an additional 7% for the following six months. Moreover, if the consumer price index rises by more than 10% between May 1980 and February 1981—a strong possibility—the entire package would be reconsidered. Persisting inflation is hitting Irish trade especially hard, promising a 1980 trade gap of at least $2 billion. Furthermore, the new wage agreement would raise the Government's budget deficit to over one billion Irish pounds, despite the prime minister's promise to hold the shortfall to £896 million. The Government's growing difficulties have triggered rumors of a general election before the year is out.

Iceland afflicted by slower growth, high inflation, and a widening current-account gap.

Iceland's National Economic Institute has issued a new set of forecasts that suggest that real GDP will grow by a little over 1% this year. The Institute projects a current-account deficit rising to 40 billion kroner—some 3% of GDP—because of the sharp rise in import (especially oil) prices. Meanwhile, the country's inflation rate continues high. The cost-of-living index showed a 10% advance in the three months ending in August, despite large subsidies of agricultural prices. The cost of living is expected to rise by more than 50% over the course of 1980, lifting the year-average price level to some 58% above that of 1979. In this context, the Government has prepared its budget for 1981, which parliament will consider this month.

Taiwan's rising oil import costs overwhelm rapid export gains.

Taiwanese merchandise exports in the first half of 1980 were 24.5% above their year-earlier level. Although overall demand in major overseas markets has weakened, owing to recession, political and economic disturbances in Korea, Taiwan's key competitor, have enabled it to increase its market share and penetrate non-traditional markets. Total export earnings this year are expected to exceed $18.5 billion, although merchandise imports are increasing even more quickly, mainly because of rising oil prices. Consequently, Taiwan may incur a small trade deficit this year—the first since 1975—while the current-account balance is likely to shift from a position of slight surplus in 1979 to a deficit of about $1.5 billion. Given Taiwan's substantial reserves and ample international credit lines, the shortfall will be relatively easy to finance. Next year, the anticipated upturn in the world economy should return the trade balance to surplus, but it may take a while longer for the current account as freight charges keep climbing and Taiwanese tourists abroad continue to outspend foreigners visiting Taiwan.

Brazil's inflation battle complicated by shutoff in Iraqi oil deliveries.

Brazil may now be seeing the beginning of a decline in its triple-digit inflation rate. The monthly rate fell to 5.3% in September from a peak of 8.4% in July. Similarly, the 12-month change in the inflation index dropped to 104% in September from its August peak of 109%. The improvement is partly a response to the Government's more highly restrictive policies of inflation control, which brought the rate of money supply growth for the first seven months of the year to well below the rate of price increase. Furthermore, the fiscal budget shifted into large surplus. There is concern that inflation-control may now be complicated by the interruption in Iraqi oil imports, which had supplied 40% of Brazilian needs. But Brazil has three months of oil stocks, and other oil exporters have offered to make up any shortfall. In the interim, gasoline prices have been boosted 18%. The Government continues to hope for an inflation rate of 80% by yearend, but such a goal is overly optimistic.

Peruvian authorities act to curb inflation and ease unemployment.

The civilian government of Fernando Belaunde that returned to power in July is faced with the pressing Peruvian problems of high inflation and widespread unemployment. To bring the country's 60% rate of inflation under control, the authorities are focusing on reducing the excessive amount of foreign-exchange inflows—which have led to sharp growth in domestic liquidity—mainly by stimulating imports. To this end, the requirement for import licenses has been removed, and tariffs have been lowered to an average level of 40%, with further reductions expected. Still, inflation is likely to climb over the next few months, possibly to as high as 70% by yearend, as a result of the removal of subsidies on a number of items. To reduce unemployment, the Government plans to boost public expenditures. This should not pose any serious budgetary burden in view of the Government's comfortable financial position, which follows from two years of tax increases and severe spending cutbacks. A more stimulative fiscal policy, together with the ongoing expansion in nontraditional exports and in the mining (and petroleum) sector may give Peru a real GDP growth rate of about 5% this year.

Sri Lanka pinning economic hopes on spurring foreign investment.

Although buffeted by higher oil bills and rapidly accelerating inflation—fueled in large part by an ambitious government investment program—Sri Lanka has had some success in promoting itself as the new frontier for multinationals. The country's potential attractiveness to foreign investors lies in its abundant supply of inexpensive but productive and trainable labor, political stability, and favorable investment climate. The Jayewardene Government is apparently following the Singapore development strategy of decontrolling prices, floating the currency, liberalizing imports, cutting back consumer subsidies, and providing generous investment incentives. The first interested investors were the textile manufacturers of Hong Kong and Singapore seeking relief from rising costs and protectionist quotas. Major international manufacturers of electronic products have also joined in, and eight foreign banks have set up branches over the last 18 months. Increased foreign investment should help Sri Lanka offset its growing import bill and trade deficit during the next few years; it should also spur the economy to meet the Government's medium-term growth target of 6% per annum in the early 1980s.

Kenya adopts price mechanism to dampen imports and stimulate exports.

Kenya's current-account deficit looks set to expand to well over $600 million this year from $455 million in 1979. Export earnings continue restrained by the weakness in coffee prices; and tea prices are only marginally above those last year. Imports, on the other hand, are climbing steadily. The crude oil import bill could reach $500 million, with earnings from the export of oil products sufficient to offset only part of the jump. Thus, the net oil deficit may hit $300 million, versus $183 million in 1979. Responding to the rise in imports, the Government replaced quantitative import controls with tariffs at mid-year. It also raised the export compensation for all manufactured goods from 10% to 20%. While these measures should have import-dampening and export-promoting effects similar to a currency devaluation, the prospect of import duties contributing to higher domestic prices is likely to negate some of the intended benefits.

Rising Rates Threaten Housing Recovery

The recent rapid rise in mortgage rates has dimmed prospects for a quick housing recovery. Indeed, recently released data indicating that new home sales fell 5% in August may be the first sign of renewed weakness in the barely recovered housing market.

Interest rates on new conventional mortgages have risen about 2% percentage points over the last three months; they are currently approaching 15% in some areas. Such an increase implies that monthly payments on new mortgages have increased dramatically. For example, the monthly principal and interest payment on a 30-year, $50,000 mortgage with a 12½% interest rate is approximately $524. If the mortgage rate rises to 14½%, the monthly payment jumps to $612, an increase of nearly 20%. Since personal income has increased by perhaps about 3% in the past three months, this rise in financing costs will undoubtedly have a depressing effect on housing demand.

Moreover, several mortgage lenders will only extend mortgages to households whose monthly incomes exceed monthly mortgage payments by a certain percentage. Consequently, a number of potential homebuyers who may have qualified for a mortgage at a 12½% interest rate will no longer qualify at the current level of rates.

The recent jump in market interest rates can also be expected to reverse the improvement in deposit flows to savings institutions—the major suppliers of residential mortgage credit—which occurred in July and August. Much of the increase in deposit flows during the summer represented flows into savings accounts, which are subject to an interest rate ceiling of 5½%. Given the magnitude of recent rises in market interest rates, it is likely that the growth of savings and other deposits subject to fixed-interest-rate ceilings will slow sharply in coming months.

Furthermore, the recent jump in interest rates has already begun to put pressure on the profit margins of these already hard-pressed savings institutions. The average maturity of their assets significantly exceeds the average maturity of their liabilities, and increases in interest rates initially have a larger upward impact on their average cost of funds than on their average return on assets. Given the recent and anticipated future volatility of interest rates, the willingness of savings institutions to make mortgage commitments has diminished in recent months.

On balance, the renewed difficulties in housing finance darken the near-term outlook for housing. And even though housing economists have at times been surprised by the resiliency of the housing market in the face of high and rising interest rates, a healthy housing recovery in the near term appears doubtful.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF				
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of credit, lions of
Asia	**Bangladesh**	Prospects for agricultural production uncertain because of serious flooding.	June	+ 15%	9.5	$ 111	Aug.	160	— 61%	0.9	1
	Burma	Public-sector investment in manufacturing increases.	July	+ 17%	4.4	134	Aug.	275	+ 38%	7.5	5
	China, People's Republic	Smaller grain harvest will restrain economic growth over the next 12 months.	June	+ [illegible]5%	515.0	510	Mar.	1,918	— 25%	1.4	
	Hong Kong	GNP growth of 10% in 1980 appears feasible, despite recession overseas.	June	+ 35%	17.6	3,320	n.a.	—	—	—	-
	India	Agricultural prospects favorable, but industrial production continues stagnant.	Apr.	— 18%	126.3	194	June	7,077	— 3%	7.8	35
	Indonesia	Foreign investment climate improving; approvals of new projects increasing.	Feb.	+ 50%	48.0	323	Aug.	5,836	+ 74%	6.4	
	Japan	External economic weakness exacerbating domestic slowdown.	July	+ 25%	1,011.0	8,725	Aug.	22,354	— 8%	1.8	
	Korea	Government seeking to consolidate and simplify overexpanded industries.	July	+ 16%	61.1	1,624	July	3,140	+ 21%	1.7	6
	Malaysia	Foreign investment and some exports slow because of recession abroad.	Mar.	+ 38%	19.4	1,457	June	4,231	+ 12%	5.2	
	Nepal	Continuing drought affects business activity.	May	— 36%	1.8	130	Aug.	176	+ 10%	1.0	1
	Pakistan	Agricultural growth to slow, but manufacturing to continue fairly strong.	June	+ 32%	21.1	275	Aug.	481	+219%	1.1	3
	Philippines	Terrorist bombings worry business, but President Marcos appears firm.	Apr.	+ 33%	29.4	617	Aug.	2,375	+ 15%	3.9	73
	Singapore	Wage increases and skilled-labor shortage slow economic growth slightly.	June	+ 50%	8.9	3,790	May	6,093	+ 12%	3.1	
	Sri Lanka	Real economic growth expected to fall to 4%-5% in 1980.	Apr.	+ 14%	3.3	226	May	401	— 6%	3.0	3
	Taiwan	GNP growth rate sustained at 6%-7%, despite recession abroad.	July	+ 26%	32.2	1,840	July	2,472	+ 24%	2.1	
	Thailand	Ample rainfall ensures good crops, providing stimulus to general business activity.	June	+ 35%	27.3	592	Aug.	2,019	— 3%	3.1	23
Oceania	**Australia**	Investment boom insulates economy from effects of world recession.	Aug.	+ 22%	119.2	8,266	Aug.	1,473	— 18%	1.4	1
	New Zealand	Outlook is for a fairly long period of little or no economic growth.	June	+ 24%	17.5	5,645	Aug.	414	— 34%	1.6	24

Further Decline Seen for Business Spending

Although the huge gains in consumer spending since May have been perceived as heralding the end of the recession, business spending has been weak and is likely to continue so. Nonresidential construction and equipment spending accounts for about 10% of GNP, compared with consumer spending's 65% share, but its cyclical volatility makes it especially important to any economic recovery. The average peak-to-trough decline in real business spending in the past five post-war recessions was three times the decline in real GNP. And swings in inventory investment are even more volatile, accounting for about one-half of the total decline in real GNP.

The high volatility of business spending stems from rational business responses. Businesses formulate capital spending and production plans and maintain inventories consistent with an expected level of sales and profitability. If sales are unexpectedly low, unplanned inventory accumulation occurs, reducing cash flow and adding to financing needs, thereby lowering profitability. To reduce inventories, production plans are scaled back. And with a lower rate of capacity utilization, profitability is further eroded since businesses' high fixed costs are spread over fewer units. With a lower level of sales and income, businesses have neither the need nor the wherewithal for new investment.

Indeed, the business sector has begun to adjust in just this fashion. When the sales slowdown began last January, the ratio of inventories to monthly sales in real terms was 1.58, about the level for all of 1979, indicating that stocks were not excessive. But by May, the ratio hit 1.73, despite production cutbacks that had started in February. Profits plunged to an annual rate of $205 billion in the second quarter from $260 billion in the first. Production dropped 8½% from January to July—bringing capacity utilization to less than 75% in July and August from 84% in January—and real capital expenditures dropped about 4% between the first and the second quarter.

Significant cutbacks in business spending still lie ahead. Despite the sharp rise in retail sales during the summer, the overall inventory-to-sales ratio has fallen only about halfway from its peak to its previous level, suggesting that unless sales continue surging, additional production declines will be needed to bring stocks into line with sales. And if the experience of the previous cycles holds, real capital investment will fall another 4% or so from the second-quarter level. This will further depress activity in the capital goods industry, where production has not yet declined sufficiently to prevent the inventory-to-sales ratio from rising. And sustained low rates of capacity utilization, coupled with renewed increases in interest rates, assure that profits will remain low. Any upturn in business spending cannot be expected before early 1981, subject to the legislative approval of tax relief.

YMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
MF il- llars	current influences on payments	latest data	consumer prices	latest data	money supply (M_1)	October 8, 1980		current monetary conditions	
	Foreign private investment to be encouraged in certain priority areas.	June	+ 9%	Apr.	+18%	.0680	+10%	Large increase in domestic credit expected in 1980/81.	**Bangladesh**
	Trade deficit narrows as terms of trade improve.	July	0	Sept.'79	+14%	.1545	+ 3%	Inflation held to about 10%.	**Burma**
	Petroleum exports to Japan to fall short of commitments.	n.a.	—	—	—	.6800	+ 2%	IMF boosts Fund quota to SDR 1.2 billion.	**China, People's Republic**
	Exports of most products continue strong.	July	+15%	June	+51%	.1990	− 3%	Money supply continues rising rapidly.	**Hong Kong**
	Export drive to be launched; liberal import policy to continue.	June	+12%	Apr.	+13%	.1250	+ 3%	Smaller budget gap eases pressure on monetary authorities.	**India**
	Net oil and gas revenues may hit $11 billion this year.	Aug.	+19%	Mar.	+40%	.001600	0	Money growth expected to be close to target.	**Indonesia**
	Factory exports should improve over next 12 months.	July	+ 8%	July	− 2%	.004795	+11%	Strong yen permits some interest-rate easing.	**Japan**
	Exports stronger, but current-account gap may top $5 billion in 1980.	July	+27%	July	+18%	.001655	−20%	Interest rates cut two percentage points in September.	**Korea**
	Oil exports support growth and trade surplus.	July	+ 7%	June	+18%	.4710	+ 2%	Inflation rate rises to 8%-10% range.	**Malaysia**
	Foreign aid expected to cover widening external deficit.	June	+15%	Apr.	+20%	.0840	+ 1%	Drought and higher oil prices lift inflation rate.	**Nepal**
	Efforts to curb imports and boost exports continue.	June	+11%	June	+17%	.1010	0	Improved fiscal stance eases pressure on central bank.	**Pakistan**
	Trade gap stabilizing near last year's level.	July	+17%	June	+13%	.1325	− 2%	Exchange rate remains stable.	**Philippines**
	Trade deficit to widen somewhat this year.	June	+10%	May	+14%	.4760	+ 3%	Strong credit demand putting pressure on interest rates.	**Singapore**
	Trade deficit to widen, owing to worsening trade terms and strong growth.	May	+30%	Apr.	+25%	.0580	− 9%	Heavy government spending crowds out private sector.	**Sri Lanka**
	Moderate current-account gap expected this year.	July	+19%	July	+21%	.0275	− 1%	Credit remains restrictive.	**Taiwan**
	Oil imports expand trade deficit.	July	+20%	Feb.	+19%	.0480	− 2%	Credit remains fairly tight.	**Thailand**
	Large capital inflows needed to finance investment projects.	June	+11%	June	+13%	1.1750	+ 5%	Monetary policy to remain restrictive.	**Australia**
	New markets for lamb opening up in Middle East.	June	+18%	June	+13%	.9815	− 1%	Pressures build for faster domestic credit growth.	**New Zealand**

World Interest Rates

market rates of Oct. 8, 1980; bond yields as of Oct. 3, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	11.80	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.50	3.00	8.25
Day-to-Day Money	12.375 Oct. 9	10.50	16.00	8.55	11.625	8.95	18.00	9.50	3.50	11.3125
Treasury Bills 91-day, Middle Rates	11.36	11.50	14.125	12.35	12.64 one-year	n. a.	16.101 115-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	11.00 finance paper	11.75 finance paper 15% tax w/h	13.56	11.60 Certified	12.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.15	11.70 15% tax w/h	14.6875	11.60 Certified	not traded	9.90	21.50	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.22	13.15	12.94	11.432 20% tax w/h	13.46	8.31	16.02	10.42	4.78	9.778
Industrial Bonds prime, long-term, new and old issues, average yield	12.85 Aa Industrials	13.70	13.80	15.33	14.27	8.56	16.33	11.35	5.64	7.33
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	13.00	17.00	15.75	13.85	11.50	21.00	11.50	5.50	8.50
Bank Time Deposits 3-month	12.00 Cert. of Dep.	11.50 Cert. of Dep.	15.3125	12.50	12.125	8.80	10.75	10.125 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	12.5625	no market	15.375	no market	12.25	8.625	no market	10.125	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8554	2.3955	.0345	.2391	.5543	.001165	.5100	.6102	.004797
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.625 *P*	2.75 *D*	.1875 *P*	.1875 *P*	3.875 *P*	11.625 *D*	2.25 *P*	7.25 *P*	2.00 *P*

Eurodollar Deposits

(London, interbank, bid)

	Oct. 9
7-day	12.5625
1-month	13.50
3-month	13.00
6-month	13.00

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .18
U.S.-Canada Treasury Bills	−1.295
U.S.-Canada Finance Co. Paper	−2.210
Eurodollars-U.K. Local Auth. Deposits	− .19

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.625
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	8.875
Over 7 yrs.	8.875

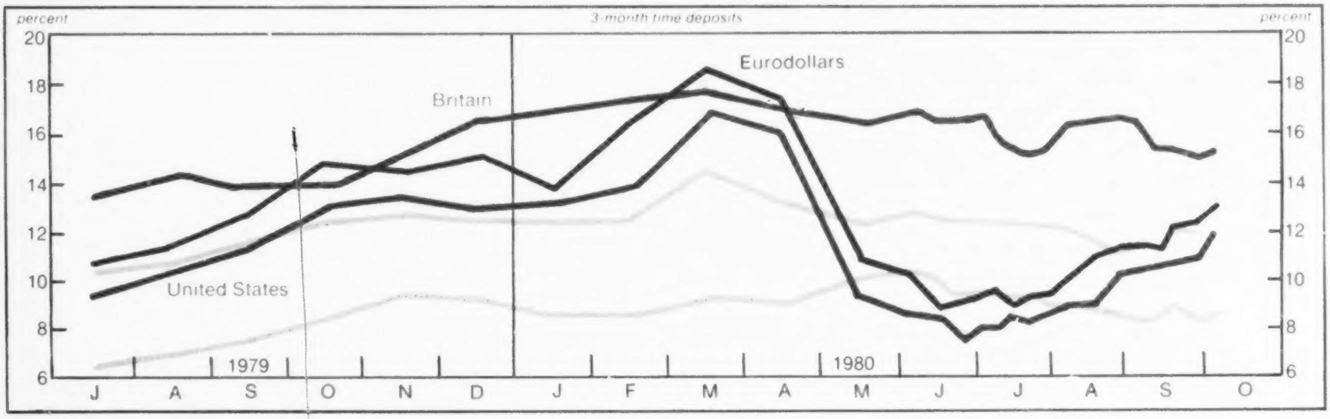
Gold Price

London
afternoon fixing

677.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirement.

Interest rate movements in major industrial countries



Portuguese Economic Progress Uneven

The 1970s proved to be a decade of turbulence for the Portuguese economy. In the ten years prior to the revolution of 1974, Portugal's economy was one of the world's fastest growing, with per capita income rising at an average annual rate of 7.1%. Economic policies were conservative and non-interventionist, producing both fiscal and balance-of-payments surpluses.

The 1974 revolution, however, wrought significant economic, as well as political, change. The laissez-faire approach was abandoned, replaced with comprehensive nationalizations, land reform, legalization of trade unions, and the establishment of minimum wages.

By 1975, wages had accelerated sharply, with productivity failing to keep pace. Investment plummeted, as did both exports and imports. Public and private consumption, however, grew substantially. The net result was a current-account deficit of about $800 million in 1975—in contrast to a surplus just two years earlier—and real GDP growth bottoming out at a negative 4.7%.

An economic recovery in 1976-77 saw Portuguese industrial production revive, while wage demands moderated in the face of rising unemployment. The 6.5% real GDP growth recorded in both years, however, was accompanied by a sharply widening current-account deficit and accelerating inflation. A current-account gap of $1.3 billion was posted in 1976, with a year-average inflation rate of 18.2%.

The balance-of-payments stress triggered a 15% devaluation of the escudo against the dollar in February 1977, along with import quotas, tighter price controls, and higher interest rates. These were followed in August 1977 by further monetary tightening and the introduction of "crawling peg" devaluations of 1% per month. Still, 1977 saw a current-account shortfall of $1.5 billion, with a jump in the average inflation rate to 27.3%, partly because of a fiscal policy that continued expansive.

Portugal's pressing need to finance its current-account deficit precipitated heavy international borrowing. Several OECD-member nations agreed to lend substantial sums, subject, however, to Portugal's adoption of a new stabilization program drawn up under the auspices of the International Monetary Fund. The adjustment program unveiled in May 1978—essentially one of monetary restraint and exchange-rate adjustment—called for a further 7% devaluation and a boost in the monthly escudo devaluations to 1.25% for 12 months, higher interest rates and taxes, slower money growth, and a cap on wage increases.

The policies were reasonably successful and produced a slowdown in real GDP growth to 3.2% in 1978. Monetary growth eased, the year-average rate of inflation fell to 22.1%, and the current-account deficit was halved. The program's effectiveness, however, continued hindered by a widening fiscal deficit.

In 1979, the Government's stabilization efforts were rewarded with a small surplus on current account, the first since 1973. It was largely the result of a policy of monetary restraint sustained for most of the year that dampened domestic demand. But an expansive fiscal budget swelled domestic credit late in the year, which combined with higher oil prices to push the average annual inflation rate back up to 24.2%.

The economic scene this year has been overshadowed to a large degree by political uncertainty. The recent victory of the Sa Carneiro Government in the October 5 general elections means that liberalization of the economy is more of a possibility. This would ultimately entail encouragement of private enterprise, a halt to the military's involvement in government, and agricultural and labor-law reform. The presidential election slated for December, however, will decide whether the Sa Carneiro leadership is able to consolidate its power sufficiently to push such policies through.

In the interim, the Government has had further success in battling inflation. The annualized rate has fallen to less than 20% (a year-over-year rate of 17.5% was posted in July), owing to a 6% revaluation and a reduction in the crawling peg devaluations, and higher consumer subsidies. Nonetheless, domestic money growth continues to advance at an annual pace in excess of 35%. This, combined with a number of postponed public-enterprise price rises, promises another upturn in inflation in 1981.

The external accounts have remained relatively healthy this year, despite a rapidly escalating oil import bill. The reasons include record tourism, rapid growth in export earnings, and large foreign remittances. The current account is thus expected to deteriorate only slightly—from a position of small surplus in 1979 to a deficit of between $600 and $900 million.

The hoped-for resurgence of private investment—particularly foreign—appears unlikely under present circumstances, and greater latitude for private-sector activity has been vetoed by the Military Council. Consequently, real GDP growth in 1980 is not expected to reach the targeted 3.5%; it will more likely be in the range of 2½%. Moreover, the new fiscal budget demonstrates that public expenditures have yet to be restrained, with the deficit set to rise to nearly 12% of GDP in 1980, as against 6.9% in 1977.

On balance, Portugal has made substantial economic progress since its adoption of stabilization policies in 1977—in the external-payments area and in the repayment of large amounts of short-term debt. A major challenge is to reduce the underlying inflationary pressures by avoiding overstimulation of the economy; and the key here is to curtail public expenditures.

Peter A. Davies
Chase London

The SDR Redefined

The International Monetary Fund recently announced that the currency basket determining the value of the Special Drawing Right (SDR) would be radically altered beginning January 1, 1981. The value of the SDR is currently a weighted average of 16 different currencies, while the new valuation method will use only five currencies weighted as follows:

	Weight (%)
U.S. dollar	42
German mark	19
French franc	13
Japanese yen	13
British pound	13

The actual valuation formula will be computed at year-end. Using average exchange rates for the fourth quarter, the IMF will seek to ensure that the SDR's valuation under both the old and new methods produces similar results on January 1 for the value of the major currencies in SDR terms.

The IMF has presumably redefined the SDR largely to encourage its use in private transactions. While a number of international banks currently accept SDR-denominated deposits, such deposits, relative to total world trade, are miniscule. The failure of the SDR to capture private transactions is partly the result of the inclusion in the 16-currency basket of many currencies that do not have well-developed spot or forward-exchange markets. Neither borrowers nor lenders have available to them a mechanism with which to hedge their SDR exposure. Thus, holders of SDR-denominated assets or liabilities risk an exchange-rate loss that cannot be insured against.

All five currencies in the new basket, however, have active spot and forward foreign-exchange markets. Hence, international investors will soon have an efficient method of hedging foreign-exchange risks associated with SDR exposure. Whether this will make a small or a large difference in the volume of private SDR transactions is not clear, but it will reduce the real costs of using SDR-denominated instruments.

An important feature of the new SDR valuation is that it will be based on the same five-currency basket that is used to compute the interest rate paid by the IMF to its SDR depositors. The IMF computation of the SDR interest rate it pays is based on such instruments as treasury bills and discounted private bills that carry interest rates 50 to 250 basis points lower than the rates on three-month Eurocurrency deposits. Furthermore, the IMF pays its depositors only 80% of the calculated interest rate.

A "Euro-SDR" rate would essentially be a weighted average of the relatively higher Eurocurrency rates. Hence, the rate on SDRs on deposit in Euromarket banks will exceed, by a non-trivial amount, the SDR interest rate calculated by the IMF. This is significant because it is the difference between Eurocurrency deposit rates that is arbitraged against the foreign-exchange forward premium (or discount). Thus, if a forward-exchange market in the SDR developed, its premium (or discount) would reflect the higher Eurocurrency rates, rather than the IMF's interest-rate formula.

This prospect raises the question of whether greater private usage of SDR-denominated instruments will lead, first, to greater competition in international financial markets for SDR business, and consequently, to market pressure on the IMF to pay its central bank depositors a "market" interest rate. Already, the IMF is considering payment of 100% of its calculated interest rate.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	**IIIQ/79**	**IVQ/79**	**IQ/80**	**IIQ/80**	**1978**	**1979**	**1980**
Gross Size (Claims)	1,041.5	1,110.7	1,117.2	1,118.0	892.7	1,110.7	1,300.0
Net Size (Claims)	635.0	665.0	675.0	710.0	535.0	665.0	785.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	258.9	269.2	274.2	285.0	222.7	269.2	320.0
Liabilities to Private Nonbank Foreigners	65.4	65.7	67.6	72.0	54.8	65.7	75.0
Total Claims on Foreigners	316.7	323.9	324.8	345.4	293.0	323.9	390.0
Claims on Foreign Public Borrowers	39.7	41.5	40.9	42.0	33.9	41.5	50.0
Claims on Foreign Private Nonbank Borrowers	113.0	118.0	118.1	128.0	104.2	118.0	135.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

CHASE

International Finance

Vol. XV, No. 21
October 27, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

10/27/80 B 1900-1 U

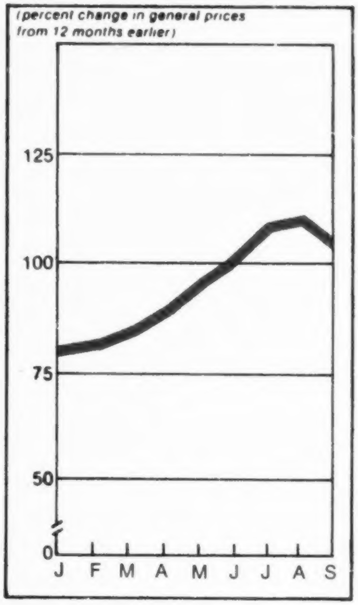
The Outlook For Brazil

There is no difficulty in explaining the increased concern over Brazil's short-term economic prospects. The rate of inflation has risen to a 16-year high of over 100%, and this year's current-account deficit is likely to reach \$12½ billion, up \$2 billion from 1979. By yearend, Brazil's foreign debt, the largest among the developing countries, will exceed \$55 billion. Furthermore, the Iraq-Iran war has forced Brazil to seek new sources to replace the 20% of Brazilian oil imports interrupted by the conflict. In these circumstances, it is hardly surprising that forecasts of the performance of the Brazilian economy are becoming less optimistic. Indeed, one forecast projects inflation to accelerate substantially and real output to decline in 1981.

Although there is little question that the growth of the Brazilian economy is slowing—and could fall short next year of the 4% rate thought to be the minimum needed to prevent a noticeable increase in unemployment—a forecast of greatly accelerated inflation and a fall in real output appears much too pessimistic. A projection of negative growth must presume an abrupt change in the willingness of the international financial community to acquire Brazilian debt. Such a scenario is highly unlikely to unfold in the near future. Thus far, Brazil has been able to fund roughly three-fourths of this year's borrowing needs, and most foreign lenders appear to remain cautiously optimistic that Brazil will carry out policies that are sufficiently restrictive to bring the trade balance and inflation under control.

The momentum of the Brazilian economy at this time is such that without the tough measures that are being taken to curb aggregate demand, foreign borrowing requirements would quickly escalate to unsustainable levels. In this event, the resultant falloff in the supply of foreign loans would force a lengthy period of extreme austerity characterized by highly unsatisfactory, although positive, economic growth rates. The initial steps toward controlling inflation and improving the balance of payments have been taken. Persistent implementation of these measures is the next challenge. In any event, Brazil's long-run growth potential remains impressive, and this argues for a measure of patience on the part of the international financial community.

Brazilian inflation



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Italy's new coalition government expected to reimpose selected tax increases.

Italy's newly formed coalition government of Christian Democrat Arnaldo Forlani is faced with several pressing economic problems. The rate of inflation exceeded 21% in the 12 months through August, industrial output in August was 5.2% below its year-earlier level, and the trade deficit for January through August totaled more than 11 trillion lira ($12.8 billion), versus 1.1 trillion lira in the corresponding 1979 period. The new government will attempt to salvage sections of the July economic package, whose failure to win parliamentary approval was the immediate cause of the previous government's fall. It will probably attempt to reimpose the July increases in the rates of the value added tax and the excise tax on gasoline that were rescinded in early October. The chances of achieving cuts in public spending or rises in the rate of income tax appear less promising. Consequently, the burden of stabilization policy will continue to fall on the Bank of Italy, which raised the discount rate to 16.5% immediately after the last government's fall to forestall speculation against the lira.

Swiss inflation outlook improves, despite sharp rises in domestic costs.

Recent data point to an improved inflation outlook in Switzerland. The consumer price index in September stood at 3.8% above its year-earlier level, and wholesale prices rose at an annual rate of only 0.5% in the June-August period. The major causes of the apparent improvement, however, have been external. The cost of imported raw materials has declined, as have the energy-related components of the price indexes. But domestic costs continue to rise sharply, and there is mounting business concern over growing wage bills. The Swiss National Bank recognizes the threat of domestically generated inflation and is expected to maintain a restrictive monetary policy through the winter wage round. Some relaxation, however, should occur in early 1981 when the impact of the current recession in Germany is felt in Switzerland. Scope will then exist for a decline in interest rates in response to weaker credit demand.

Canadian trade showing strong, but 1980 current-account deficit will widen.

Canada's foreign trade performance is relatively strong in this recession year. Reasons include the domestic demand slowdown itself, which has led to a decline in real import volume, and the faster upward movement of export prices relative to import costs. These influences have contributed to a merchandise trade surplus of C$4.5 billion for the first seven months of this year, compared with a trade surplus of just under C$4 billion for all of 1979. Export prices have been notably strong for wheat, metals and minerals, and forest products. The Canadian trade gains have offset some of the C$1-billion rise in the services deficit in the first half of this year. A continuation of these trade trends will limit the size of the overall current-account deficit for 1980, although the shortfall is still expected to exceed the C$5.1-billion current-account gap of last year.

Indian economy hit hard by the Iran-Iraq conflict.

The disruption of oil supplies precipitated by the Iran-Iraq conflict poses a serious threat to the Indian economy. Iran and Iraq together had satisfied nearly two-thirds of Indian oil import requirements, and since India is relatively near to the Gulf, it was hit sooner than most other countries by the cutoff in supplies. India is currently scrambling to obtain 350,000 tons of crude oil and 125,000 tons of refined products on the spot market. It has also approached other oil-exporting countries, and Kuwait and Bulgaria have agreed to make up some of the shortfall at market prices. The Soviet Union, however, has indicated that it is unable to provide immediate aid. The higher prices paid for oil imports will boost the Indian oil bill above the $6-$7 billion already projected for the fiscal year. Consequently, a trade deficit of more than $4 billion in fiscal 1980/81 is virtually assured, unless non-oil imports are severely restrained. The urgency of the situation has put the Gandhi Government under increasing pressure to resolve the 11-month dispute in Assam that has cut off one-third of India's domestic production. It is also likely to prompt the authorities to move more quickly in opening exploration blocks to foreign oil companies.

Holland's rising unemployment and inflation spurs reassessment of fiscal policy.

Rapidly rising unemployment in Holland combined with accelerating inflation—consumer prices rose 7% in the 12 months through August—have prompted a debate on the nature of fiscal policy and the role of wage indexation. The relatively restrictive 1980 incomes policy, whereby wage increases are limited to rises in the cost of living, will not be maintained in 1981. But the government has consented to present to the trade unions plans for amending the 1981 draft budget. Specific proposals call for a substantial relaxation of the Dutch system of wage indexation in return for wide-ranging income tax cuts. Such tax reductions would be covered partly by rises in indirect taxes, including the value added tax, and partly by increased public borrowing. If these proposals are accepted, the actual 1981 budget deficit will exceed the originally proposed 13.1-billion guilder shortfall. And since the economy is on the verge of recession, the actual 1981 budget gap may even exceed the estimated 14.7-billion guilder budget deficit for 1980.

Venezuelan recession may result in real GDP contraction of 2% this year.

The Venezuelan economy continues in recession. According to statistics for the first half of 1980, automobile and cement sales, reliable indicators of industrial and construction activity, dropped 10% and 2% from their year-earlier levels. Petroleum production has also declined, in contrast to its upsurge a year ago, with output averaging 2.1 million barrels per day through end-September, compared with 2.3 million during the same period in 1979. Economic activity is unlikely to pick up in the second half because the authorities are pursuing a restrictive fiscal policy, and because of an uncertain business environment. Consequently, real GDP may decline by about 2% this year, after registering growth of less than 1% in 1979. And although the year-over-year rate of inflation reached 24% by June, the monthly increments have been decelerating recently. Thus, barring the renewal of price decontrol, the inflation rate may slow to about 20% by yearend.

Singapore is well-cushioned against economic downturn.

Singapore's economy has been barely affected by the current economic downturn in the industrialized nations. The economic growth rate this year is expected to reach at least 8%, largely on the strength of a bargeoning business and financial services sector and a property market boom. Manufacturing, growing at about 13%, is also doing well, with the electronics and transport industries setting the pace. Singapore's good fortunes rest on two cornerstones. First, it has carved out for itself a comfortable niche in the regional economy, servicing the development needs of its two well-endowed neighbors, Indonesia and Malaysia. And second, the government's well-orchestrated program to boost certain high-technology industries has attracted foreign investors and pushed Singapore a step ahead of other Asian competitors in the technological race. These twin strengths should help Singapore sustain its current fast-paced development through 1981 and beyond.

Algerian energy development plans shift in response to higher oil prices.

Rising oil prices have led to Algeria to reassess its energy development policies. Previous plans called for the development of gas resources at the greatest possible speed by constructing several liquefied natural gas plants for export of LNG to Europe and the United States. Such plans would have entailed heavy Algerian investment in plants as well as LNG carriers. Higher oil revenues, however, have brought about significant policy changes. Plans for the extraction of all forms of gas have been pared—although current production is expanding—and there has been a shift toward pipeline gas exports, instead of LNG. Pipeline gas generally commands a higher f.o.b. price, and shifts the burden of investment more to the consuming country. These new energy policies are expected to keep Algeria's current account in approximate balance over the long term. Although Algeria will probably return to the international capital market in 1981, future borrowing levels will most likely be low, averaging $2-$3 billion per year, a level sufficient merely to roll over maturing debt.

The U.S. Economy

The Elusive Balanced Budget

News is just about to break concerning the exact size of the fiscal 1980 federal budget deficit. And it will be a huge one. The Office of Management and Budget (OMB) is due to release the official figures later this week. However, private economists have already estimated that the deficit for fiscal 1980, which ended September 30, may be as high as $65 billion. This would be some 63% greater than OMB's $40-billion projection of the 1980 deficit made last January.

Much of the unexpected swelling of the deficit has been blamed on the recession, and rightfully so. As unemployment rises during a recession, spending associated with various federal income maintenance programs goes up. And as business activity slows, so does the flow of revenues into federal coffers.

But the recession was not the only contributor to the higher-than-expected federal spending in 1980. Military and political turmoil in Afghanistan, Iran, and other areas of the Middle East prompted an explicit change in defense policy. Estimates of U.S. military defense spending for 1980 had to be revised upward by almost 4½% between the beginning of the year and late summer, accounting for over one-fourth of the increase in the projected deficit. Furthermore, in its zeal to protect federal spending programs from the ravages of inflation, Congress has further complicated the task of achieving a balanced budget. More than 75% of all government outlays are now indexed in some way to the inflation rate, so that when prices go up, government expenditures rise as well.

There are now encouraging signs that an economic recovery is already under way. However, the turnaround is not likely to be sufficient to bring about any significant reduction in Washington's red ink over the next year. On the revenue side, pressures for tax relief have by no means subsided. And although it is impossible at this point to predict the exact size of any tax cut, the form it will take, or when it might take effect, all of the proposals that have been put forth thus far would contribute significantly to the expected shortfall between receipts and spending. As for expenditures, the renewed interest in supplementing American military readiness will likely protect the defense budget from any serious Congressional cost-cutting efforts in fiscal 1981. And the prospect of continued high inflation limits the extent to which policymakers can economize elsewhere.

Consequently, although fiscal 1981 was targeted by the Carter Administration as the year in which budget balance would be achieved, it is not likely to come any closer to that goal than did the fiscal 1980 budget. And it will mark the 13th consecutive year in which a federal deficit is recorded.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE			
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	Declines in industrial and farm output produce 2.9% GDP drop in second quarter.	June	− 27%	102.1	$3,825	June	8,142	+ 8%	11.8
Brazil	Restraints placed on wage increases to help curb 100% + inflation rate.	June	+ 35%	209.1	1,760	May	5,789	− 46%	2.8
Chile	Real GDP growth expected to slow to 5% in 1980 from record 8.5% in 1979.	July	+ 44%	20.6	1,860	Aug.	2,812	+ 75%	6.8
Colombia	Measures taken to reduce tax burden on coffee exporters.	June	+ 21%	28.2	1,070	Aug.	4,383	+ 31%	10.7
Costa Rica	Economic growth slowing in response to tightening of fiscal and monetary policy.	June	+ 12%	3.9	1,760	July	77	− 13%	0.7
Ecuador	Manufacturing activity and government spending boost the economy.	Feb.	+ 51%	8.7	1,070	Aug.	979	+ 42%	5.6
Guatemala	Monetary council injects more than $100 million into commercial banking system.	Dec.	+ 9%	7.2	1,060	Aug.	558	− 20%	7.1
Honduras	Government undertaking international campaign to promote tourism.	Mar.	+ 27%	1.9	540	June	228	+ 21%	1.6
Guyana	Special IMF/World Bank cooperation program will aid economic development.	Dec.	+ 12%	.5	625	July	14	− 70%	0.4
Haiti	Local assembly industry and aid inflows help economy.	Oct. '79	+ 1%	1.5	300	Mar.	44	− 15%	n.a.
Jamaica	Economic deterioration continues; presidential election set for October 30.	Apr.	+ 13%	2.7	1,230	July	165	+ 69%	1.9
Mexico	Overall level of economic activity high, but agricultural and electrical output lagging.	July	+ 83%	117.9	1,700	Apr.	2,298	+ 11%	1.3
Nicaragua	Agricultural production up to 70% of pre-war level.	Dec.	− 5%	1.7	660	Nov.	85	+ 42%	1.7
Panama	Wage increases and higher farm supports boost price level.	May	+ 34%	2.7	1,420	July	82	− 63%	0.7
Paraguay	Restrictive monetary and fiscal measures hold inflation to 6.9% in first half of 1980.	July	− 17%	3.7	1,225	Aug.	733	+ 27%	15.5
Peru	Wage increases permitted to restore purchasing power, but price decontrol continues.	Mar.	+ 66%	12.1	700	June	1,824	+243%	9.0
Puerto Rico	Real GDP growth slowed to 2.3% in fiscal year ending June 1980.	June	0	10.2	2,925	Aug.	8,372*	+ 9%	21.0
Venezuela	Foreign reinvestment exceeding Andean Pact limit of 7% of original capital outlay is approved.	May	+ 49%	45.2	3,350	Aug.	8,108	+ 57%	9.1

*Commercial bank deposits

Business Borrowing Shifts Back to Banks

Business loan growth at banks has accelerated sharply since early summer. This acceleration does not, however, reflect a widening of the "gap" between capital expenditures and internally generated funds at nonfinancial corporations. Rather, it reflects a shifting in the sources, and to some extent the uses, of funds raised by corporations.

Since early July, business loans at large banks have grown at a seasonally adjusted annual rate of 18%. This compares with a 7% decline in such loans from early April to early July. Yet based on limited data on corporate profits and capital expenditures in the third quarter, it appears that the difference between capital expenditures and internally generated funds of nonfinancial corporations (or the "financing gap") was actually below that of the second quarter by as much as 68%. This contrasts with the usual positive correlation observed between this financing gap and business loan growth.

There are a number of reasons for this somewhat atypical behavior of loans. For one, businesses have increased their holdings of financial assets in the third quarter; in the second quarter, these holdings were actually run down at a seasonally adjusted annual rate of $19.4 billion.

More importantly, the composition of nonfinancial corporate liabilities shifted dramatically. First, there is clear evidence that the debt maturity lengthening that began last spring was sharply curtailed during the third quarter. New issues of corporate bonds fell substantially from their record increases during the second quarter, with successive monthly declines during July through September. Second, there was a significant shift in the composition of short-term liabilities. Nonfinancial corporations liquidated short-term commercial paper during the third quarter, after issuing paper in the second quarter at a $20.2-billion seasonally adjusted annual rate.

This shift in liability composition reflects several changes in conditions of credit availability. For one, long-term bond rates have risen sharply since mid-June. Given this increased cost of long-term funding, many firms have postponed new debt issues until interest rates move down. For another, there was a significant decline in the cost of borrowing at banks relative to the cost of raising funds in the commercial paper market. For example, the spread between the prime rate and the 90-day commercial paper rate fell from 700 basis points in May to 130 basis points in September. This decline reflected to some extent the lowering of reserve requirements, which reduced the reserve "tax" on funds raised by banks.

In sum, much of the recent strength in bank loans stems from two forces. First, firms have engaged in temporary short-term financing in the expectation that bond market conditions improve. Second, bank loans have become more attractive relative to other short-term alternatives.

PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF dit, mil- of dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M_1)	exchange rate in U.S. dollars October 22, 1980	change from year earlier	current monetary conditions	
	Mini-devaluation rate set at 1% monthly.	Sept.	+ 84%	Apr.	+146%	.00052	−22%	Interest rates decline slightly.	**Argentina**
	Minimum financing terms imposed on imports.	Sept.	+104%	Aug.	+ 76%	.0175	−47%	Cruzeiro loans limited.	**Brazil**
	Current-account deficit of $1.3 billion expected for 1980.	Aug.	+ 33%	June	+ 65%	.0270	+ 5%	Net foreign assets rising.	**Chile**
	Jan.-July coffee exports up 37% above year-earlier level.	June	+ 28%	Mar.	+ 31%	.0230	−11%	Credit crunch easing.	**Colombia**
	Dual exchange rate in effect to stem import growth.	June	+ 19%	June	+ 8%	.1200	+ 3%	Credit policy is restrictive.	**Costa Rica**
	Industrial exports show large increase.	June	+ 12%	May	+ 25%	.0385	− 4%	Pace of import financing steps up.	**Ecuador**
	Foreign-exchange rules tightened for travel abroad.	July	+ 12%	June	+ 19%	Par	—	Reserve requirements lowered.	**Guatemala**
	Coffee export receipts likely to reach $230 million in 1980.	Apr.	+ 22%	June	0	.5010	0	Monetary policy is restrictive.	**Honduras**
	Higher sugar prices help export earnings.	Mar.	+ 17%	July	+ 6%	.4000	+ 2%	Monetary growth restricted.	**Guyana**
	Toy and sporting goods exports increasing.	Mar.	+ 22%	Mar. '79	0	.2010	+ 1%	Increased monetization of economic activity.	**Haiti**
	Jan.-Sept. bauxite exports were 9% below year-ago level.	May	+ 26%	Apr.	+ 29%	.5700	+ 2%	Net foreign assets decline further.	**Jamaica**
	Oil exports reach 60% of total foreign sales.	July	+ 28%	Apr.	+ 25%	.0433	− 1%	Eurodollar borrowing increases.	**Mexico**
	New credit restrictions adopted to reduce imports.	Dec.	+ 30%	Aug.'79	+ 56%	.1010	+ 1%	Liquidity is tight.	**Nicaragua**
	Merchandise imports have doubled since 1979.	June	+ 13%	Apr.	+ 11%	Par	—	Demand for credit is strong.	**Panama**
	Capital inflows more than offset trade deficit.	May	+ 34%	Feb.	+ 22%	.0080	+ 1%	Guarani financing very limited.	**Paraguay**
	Cumulative 1980 trade surplus is $1.5 billion to date.	Mar.	+ 60%	Mar.	+ 87%	.0039	−21%	Credit growth is limited.	**Peru**
	Tourism this past summer down 12% from year ago.	Aug.	+ 7%	Aug.	+ 9%	Par	—	Credit growth is moderate.	**Puerto Rico**
	Import demand remains depressed.	July	+ 24%	May	+ 13%	.2329	0	Net foreign assets rising.	**Venezuela**

World Interest Rates

market rates of Oct. 22, 1980; bond yields as of Oct. 17, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	11.60	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	8.25
Day-to-Day Money	12.9375 Oct. 23	11.75	18.50	11.50	11.125	9.05	17.875	9.00	0.75	11.125
Treasury Bills 91-day, Middle Rates	11.76	11.30	14.25	12.10	12.60 one-year	n. a.	15.80 101-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	11.75 finance paper	11.30 finance paper 15% tax w/h	14.07	11.60 Certified	11.6875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.50	11.35 15% tax w/h	15.9375	11.60 Certified	not traded	9.90	21.50	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.41	13.10	12.95	11.085 20% tax w/h	13.57	8.29	16.13	10.05	4.74	8.60
Industrial Bonds prime, long-term, new and old issues, average yield	12.45 Aa Industrials	13.75	13.78	15.815	14.43	8.38	16.38	10.99	5.6875	7.30
Bank Short-Term Rate to Best Borrowers (prime rate)	14.00	12.75	17.00	15.75	13.85	11.50	21.00	11.00	5.50	8.50
Bank Time Deposits 3-month	12.50 Cert. of Dep.	11.15 Cert. of Dep.	16.125	12.10	11.6875	8.75	10.75	9.375 large deposits	5.125 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	13.5625	no market	16.375	no market	12.00	8.75	no market	9.50	5.3125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8554	2.4320	.0334	.2336	.5363	.001133	.4935	.6015	.004780
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.375 *P*	3.00 *D*	.125 *P*	1.75 *P*	4.50 *P*	8.375 *D*	4.00 *P*	8.125 *P*	3.50 *P*

Eurodollar Deposits
(London, interbank, bid)
Oct. 23

7-day	14.75
1-month	14.125
3-month	13.5625
6-month	13.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+3.635
U.S.-Canada Treasury Bills	−1.455
U.S.-Canada Finance Co. Paper	−1.77
Eurodollars-U.K. Local Auth. Deposits	+ .123

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.50*
Over 7 yrs.	13.40*
DM Bonds	
7 yrs. and under	8.75*
Over 7 yrs.	8.75*

Gold Price
London
afternoon fixing
660.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Bond yields as of Oct. 10.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.8 (Aug.)	10.7 (Sept.)	15.9 (Sept.)	13.6 (Aug.)	5.2 (Sept.)	21.2 (Sept.)	3.8 (Sept.)	8.7 (Aug.)
Industrial production*	−6.7 (Sept.)	−4.0 (July)	−8.1 (Aug.)	−3.6 (July-Aug.)	−1.0 (Aug.)	−5.2 (Aug.)	9.0 (Mar.)	2.0 (Aug.)
Trade balance† *(billions of local currency units)*	−$1.06 (Aug.)	C$1.04 (Aug.)	£0.37 (Sept.)	−FF5.44 (Sept.)	−DM0.13 (Aug.)	−Lit.1,630 (Aug.)	−SF1.10 (Sept.)	¥412 (Sept.)
Money supply (M_1)*	4.5 (June)	3.8 (July)	2.8 (June)	8.5 (May)	1.6 (June)	19.9 (Apr.)	−11.4 (July)	0.6 (June)
Velocity of money (M_1)*	3.5 (June)	10.7 (June)	11.7 (Mar.)	n. a.	5.8 (June)	4.3 (Mar.)	n. a.	5.7 (June)
Reserves minus gold *($ million, change from previous month)*	750 (Aug.)	−278 (July)	34 (Aug.)	321 (Aug.)	33 (Aug.)	−1,131 (Aug.)	−310 (Aug.)	254 (Aug.)

* Percent change from 12 months earlier

† Figures are only for the month indicated

Angola: An Economy Reemerging

Despite its military ties with the Soviet Union and Cuba, the newly independent African nation of Angola has refused to join the COMECON group and is actively cultivating commercial relations with the West. The former Portuguese colony, which achieved independence in 1975, has established official relations with virtually all of Western Europe and has forged commercial ties with the United States in an effort to obtain economic, technical, and financial assistance. Such aid is sorely needed by the Angolans to rebuild an economy that has yet to recover from its severe contraction following the exodus of the Portuguese and a protracted period of civil war. The country's ace-in-the-hole, however, is its rich agricultural and mineral-resource base, and especially its oil.

Angola's oil sector has clearly spearheaded the economic recovery that has occurred to date. Although oil production returned to its pre-independence level as early as 1977 and continues to expand steadily, all other economic sectors—agriculture, industry, and non-oil minerals—remain depressed. Significantly, Angola, which prior to independence was totally self-sufficient in food, has become heavily dependent on imports.

Official statistics on Angola's economic performance are unavailable, but it appears that 1978 marked the first year of economic growth since independence was won and a program of comprehensive nationalization was undertaken. Real GDP growth reportedly exceeded 20% in 1978 and in 1979, but 1978 GDP in constant prices was nearly 40% below the level prevailing in 1971.

The government's efforts to revitalize agriculture with large-scale state farms have been constrained by a severe shortage of skilled labor and investment capital, and a revival of industrial production has been hampered by the suspension of import licenses for industrial raw materials in the second half of 1979. The non-oil mineral sector has also languished. Diamond production is still far below the two million carats produced annually prior to independence, and output of iron ore—3.1 million tons in 1974—remains at a standstill.

The oil sector, however, is booming. Reserves are estimated to be at least 300 million tons, 140 million of which are proven. Oil output is expected to average 160,000 barrels per day (bpd) in 1980, up from 146,000 in 1979. With domestic consumption projected at about 13,000 bpd this year, exports averaging some 147,000 bpd are likely, versus exports of 135,000 bpd last year. Gross oil export revenues are thus expected to rise to $1.9 billion from less than $840 million in 1979, with the majority of revenues derived from North America—60% from the United States alone in 1978. The Angolan Government has shared production with foreign oil companies and will continue to do so, although it plans to place its oil distribution system under state ownership. It also plans to apply for OPEC membership.

Oil exports will account for some 83% of the $2.25 billion in total export earnings projected for 1980. This level is almost double export receipts last year. Thus, despite total imports likely to rise to an estimated $1.4 billion this year (37% of which are of foodstuffs, with the remainder mostly capital equipment), a trade surplus of $850 million is forecast, up sharply from the $50-million surplus of 1979. A negative invisibles balance of about $350 million is expected, owing to the outward remittances of foreign technical personnel. This points to a current-account surplus of roughly $500 million this year, in contrast to a deficit of $35 million in 1979.

Although capital goods imports will probably climb steeply along with widening deficits on the invisibles account, steadily rising oil earnings and a strong potential for a broadened export base point to current-account surpluses for much of the current decade. Even so, the Angolan authorities have sought to maintain creditworthiness in international financial markets by promptly meeting debt payments and even assuming the credit obligations of the pre-independence regime.

Foreign investment courted

Underscoring its desire to rebuild its economy as rapidly as possible with Western investment, the Angolan Government promulgated a liberal foreign investment law in June 1979. The law guarantees foreign enterprises at least 10 years of business activity, provides for compensation in the event of nationalization, allows repatriation of annual profits of up to 25% of invested capital, and permits access to domestic credit for financing current operations. It excludes foreign investment in defense, financial and insurance institutions, external trade, public services, and the media. The law's liberal provisions have attracted substantial interest from European, Brazilian, and American businesses, with major contracts already signed by a number of foreign oil companies.

The Angolan economy could experience a rapid takeoff in the current decade, given its natural (and particularly, oil) resource wealth, and its encouragement of foreign investment. Much, however, will depend on the authorities' ability to maintain political stability and also on a relaxation of tensions on the southern border with Namibia. Resolving the latter problem would permit a reduction in the 25% of total budgeted outlays now allocated to defense, restore full service on the vital Benguela Railroad, and exploit the vast agricultural richness of the southern region. If political stability is maintained, and coupled with sound demand-management policies that favor investment, Angola could enjoy rapid economic growth in the 1980s.

Wally V. Koch

Belgium Faced With Widening Deficits

Belgium's open economy has yet to recover fully from the OPEC oil price shock of 1973-74. Prior to 1973, inflation-adjusted economic growth was brisk and steady—averaging 4.8% per annum between 1960 and 1973—and the external accounts were generally in surplus. In the latter half of the 1970s, however, industrial production has been virtually flat, manufacturing investment has fallen continuously, and the external-account deficit has widened sharply.

The 1973-74 oil crisis forced a severe economic adjustment. With virtually all wages and salaries indexed to the cost of living, a downward adjustment in real wages was essentially precluded. Consequently, the full brunt of the adjustment fell on industrial profits, investment, and employment. Moreover, periodic speculative attacks on the Belgian franc had to be countered with restrictive monetary policy, which further undermined industrial investment and employment. The consequent loss of export competitiveness—so critical to a country whose foreign trade is equal to one-half of GDP—could not be offset by a currency devaluation because the resulting higher import prices would only have shown up in higher wage costs.

Responding to the rise in unemployment, the authorities stepped up public spending and expanded the public deficit. This sustained domestic demand temporarily, but created a current-account shortfall and necessitated substantial foreign borrowing. The government's external debt grew from virtually zero in 1977 to $2 billion as of end-1979 and rose to $3.1 billion in March 1980. While such a foreign debt burden is relatively low, the trend underlines the need for an external reduction in the current-account deficit.

After advancing 2.5% in 1978, the pace of real GDP growth stepped up last year to 3.5%, the result of highly stimulative fiscal policy and faster world trade growth. At the same time, the public-sector deficit rose to a level equivalent to 9% of GNP from 7.2% in 1978. Stimulated by rapid economic growth in Europe, export volume rose 4% last year, but this was still less than the growth in the import volumes of Belgium's trading partners so that the country continued to lose market share.

Membership in the European Monetary System held the rate of inflation to 4.4% last year, roughly approximating Germany's 4.1% rate. But strong domestic demand boosted import volume 5.7%, which, coupled with costlier oil imports, widened the country's current-account deficit to $3.8 billion from $880 million in 1978. Some $2 billion of this deterioration was the result of a net oil bill that reached $6 billion.

Despite a continuation of expansionary fiscal policy, a sharp slowdown in Belgium's real economic growth appears likely for 1980, along with further widening in the balance-of-payments deficit. The major sources of weakness are exports and investment. Export volume growth is expected to fall to 1.5%—reflecting the European economic slowdown—and private investment is forecast to decline because of the continuing squeeze on profits, high interest rates, and slower growth in consumer spending.

Domestic demand will likely be sustained somewhat by a further rise in the public-sector deficit to 9.4% of GNP. This increase in government expenditure will occur despite earlier proposals to cut spending drastically, which continue to be blocked by political difficulties. Prime Minister Wilfred Martens submitted his government's resignation on October 4 over a dispute concerning cutbacks in social security and unemployment benefits. A fourth Martens coalition government was just sworn in, but it remains to be seen whether it will be any more successful in reducing the public-sector deficit.

All told, real GDP growth of only 1.5% is projected for 1980, less than half last year's rate. And the rate of inflation is forecast to climb to 6.5%, the result mainly of higher import prices. But the most worrisome feature of the Belgian economic performance in 1980 is the balance of payments. This year's rise in oil prices will add about $3 billion to the net oil bill. And with domestic demand growing faster than export demand, the current-account gap could top $7 billion.

The size of the current-account gap may bring about some shift toward a more restrictive fiscal policy late in 1980—subject to a resolution of the current political uncertainty—which would portend a further slowdown in domestic demand in 1981. Although recession in Belgium's trading partners is likely to continue until mid-1981, foreign demand should accelerate in the latter part of 1981. Thus, 1981 will also see slow economic growth, but with improvement likely in the second half. Inflation can also be expected to ease in line with inflation rates throughout Europe, and the current-account deficit may decline somewhat, assuming no further drastic cutback in oil supplies in the wake of the Iran-Iraq war.

The alarming growth of Belgium's current-account deficit must ultimately be addressed. Reducing the deficit can be accomplished in either of two ways: abandoning wage indexation and devaluing the franc, which would reduce real wages but boost output and employment; or deflating domestic demand with restrictive fiscal policy, which would further increase unemployment. Both of these options, however, are politically difficult. Nonetheless, in the event that external pressures mount—perhaps in the form of harder terms on foreign credit—the necessary political consensus will very likely emerge.

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